First Report

of the

Commission on Taxation

DIRECT TAXATION

July 1982

Irish Taxation Institute Library

Accession Number _____ **Classification Number** _____

ARNA FHOILSIÚ AG OIFIG AN tSOLÁTHAIR.

Le cumhdach díolta ó

OIFIG DHÍOLTA FOILSEACHÁN RIALTAIS, AN STUARA, ARD-OIFIG AN PHOIST,
BAILE ÁTHA CLIATH 1,
nó trí aon díoltóir leabhar.

DUBLIN:
PUBLISHED BY THE STATIONERY OFFICE.

To be purchased from the
GOVERNMENT PUBLICATIONS SALE OFFICE, G.P.O. ARCADE, DUBLIN 1,
or through any Bookseller.

Pl. 617 £12.00

THE COMMISSION ON TAXATION

Members:

Miriam Hederman O'Brien (Chairman)
Donal Carroll
Derek Chambers
James Gallagher
Camilla Hannon
Daniel Murphy
Donal Murphy
Donal Nevin
Patrick P. O'Neill
Raymond O'Neill
W.J. Louden Ryan

Secretariat:

Donal de Buitléir	(Secretary)
William Hennessy	(Assistant Secretary)
Paul Molloy	(Research Officer)
John Hamill	

TABLE OF CONTENTS

Introduction	25
Key Elements of Proposed Reform	29
Summary of Recommendations	45
Glossary	59

PART I

GENERAL PRINCIPLES

Chapter	Paragraph	Page
1. **The Irish Tax System in Perspective**		
Introduction	1.1	67
Terms of Reference	1.3	67
Development of the Irish Tax system	1.7	68
Economic Growth	1.13	70
Inflation	1.14	71
Public Finances	1.15	71
Budgetary Policy	1.21	73
Structure of Tax Revenue in Ireland	1.24	75
Summary	1.29	77
Public Finance Options	1.30	78
Conclusion	1.33	79
2. **Criticisms of the Taxation System**		
Introduction	2.1	80
Equity	2.3	80
Simplicity	2.10	81
Incentives	2.11	82
Conclusion	2.15	82
3. **Criteria for Tax Systems**		
Introduction	3.1	83
Equity	3.2	83

Chapter	Paragraph	Page
Efficiency	3.7	84
Simplicity	3.10	85
Conclusion	3.14	86
International Constraints	3.16	86
Tax Expenditures	3.18	87
Recommendation	3.22	88
4. Appraisal of Various Taxes		
Introduction	4.1	89
Personal Income Tax (including employees' social insurance contributions)	4.2	89
Grants	4.4	90
Capital Gains Taxes	4.5	90
Gift and Inheritance Taxes	4.6	90
Payroll Taxes	4.7	91
Corporation Tax	4.8	91
Direct Expenditure Tax	4.10	91
Indirect Taxes	4.13	92
Stamp Duties	4.16	93
Wealth Tax	4.17	93
Property Taxes	4.18	93
Conclusion	4.19	94
5. Incidence of Taxation		
Introduction	5.1	95
The Concept of Incidence	5.2	95
Pay Determination	5.4	96
Companies	5.8	97
Agriculture	5.13	99
Devaluation	5.14	99
Tax Capitalisation	5.16	100
Conclusion	5.17	100
6. Taxation and the Distribution of Income		
Introduction	6.1	101
The Approach	6.2	101
Tax and non-Tax Policies in Redistribution ...	6.4	102
The Distributional Objective	6.8	103
7. Inflation and Taxation		
Introduction	7.1	104
Inflation in Ireland	7.2	104
Payment of Tax	7.5	105

Chapter	Paragraph	Page
Fiscal Drag	7.6	105
Inflation and Personal Income Tax	7.9	107
Specific Taxes and Inflation	7.15	109
Inflation and Other Taxes	7.17	110
The Tax Base	7.19	110
Conclusion	7.24	112
Recommendation	7.26	112

PART II

DIRECT TAXATION

8. The Definition of the Tax Base		
Introduction	8.1	115
Equity Principles	8.2	115
Present Definition of Income	8.4	115
A Comprehensive Definition of Income ...	8.6	116
Inflation and the Definition of the Tax Base ...	8.9	117
Implementation	8.14	119
Direct Expenditure Tax	8.17	119
Conclusion	8.23	120

PART IIA

THE TAXATION OF INDIVIDUALS

9. Present Income Tax System in Ireland		
Introduction	9.1	125
Present System	9.2	125
Historical Background	9.9	126
Conclusion	9.18	128
10. The Widening of the Income Tax Base		
Introduction	10.1	129
(i) The Taxation of Imputed Income	10.3	129
Housing	10.4	129
Categories of Housing	10.8	131
Owner-occupied Housing	10.9	131

Chapter	Paragraph	Page
Local Authority Housing	10.10	132
Privately-rented Housing	10.11	132
Historical Background	10.12	133
Abolition of Schedule A	10.16	134
Rates Relief on Domestic Property	10.18	134
Summary	10.19	135
Proposed Tax Treatment of Housing	10.21	136
(ii) Exempt Income	10.29	138
Short-term Social Welfare Benefits	10.30	138
Compensation Payments for Loss of Office ...	10.42	141
Lump Sum Retirement Benefits	10.45	143
Payments under the Redundancy Payments Act	10.49	144
Compensation Payments for Physical or Other Injury	10.50	144
Foreign Pensions	10.53	145
Artists' Exemption	10.55	145
Payments under the Aosdana Scheme	10.60	146
Casual Gambling Winnings	10.61	146
Exemption of Sweepstake and Lottery Profits	10.64	147
(iii) Deductions from Income	10.66	147
Provision for Ill-health	10.67	147
Medical Insurance Premiums	10.68	148
Health Expenses	10.70	148
Permanent Health Insurance Schemes	10.72	149
Relief for Expenditure on Residential Premises	10.74	149
Schedule E Expenses	10.77	150
Relaxation of Schedule E Expenses	10.79	150
Expenses Incurred in Travelling to and from Work	10.80	151
Relief in Respect of Educational Expenses ...	10.85	152
Schedule E Employee Allowance	10.90	153
Interest on PAYE Tax	10.93	154
Annual Payments	10.94	154
Covenants between Separated Spouses	10.104	156
Recommendations	10.108	157
11. The Taxation of Borrowing and Saving		
Introduction	11.1	159
Effect of Income Tax Concessions on the Allocation of Saving	11.3	159
Inflation and the Return from Savings	11.7	160
Loan Interest	11.16	162

Chapter	Paragraph	Page
Interest and Inflation	11.21	164
State Aid for House Purchase	11.25	165
Exemption of Deposit Interest	11.27	165
Composite Rate Arrangement for Building Societies	11.34	167
Relief to Individual Shareholders in Certain Irish Companies	11.41	169
Relief on Dividends Paid Out of Export Relieved Profits	11.45	169
Relief for Superannuation Contributions ...	11.46	170
Retirement Annuities	11.54	172
Individual Retirement Accounts	11.60	173
Relief for Life Insurance Premiums	11.61	173
National Savings Schemes	11.73	176
Recommendations	11.74	177
12. The Taxation of Fringe Benefits		
Introduction	12.1	179
Definition	12.3	179
Benefits Chargeable	12.8	180
Benefits not Chargeable	12.9	181
Operation of Existing Legislation	12.10	182
Taxation of Benefits	12.11	182
Frequency of Fringe Benefits in Ireland ...	12.13	183
Discounts to Shareholders	12.15	184
Scheme for Taxation of Fringe Benefits ...	12.16	184
Market Value	12.17	185
Types of Benefits	12.19	185
Cars	12.20	186
Loans at Preferential Rates of Interest	12.28	188
Living Accommodation	12.33	190
Insurance	12.34	190
Medical Insurance	12.35	190
Permanent Health Benefit	12.36	191
Life Assurance	12.38	191
Free, Subsidised or Discounted Goods and Services	12.39	192
Provision of Meals	12.41	192
Educational Expenses	12.43	193
Free Medical Services ...	12.45	193
Free or Subsidised Transport Facilities	12.46	193
Recreational Facilities	12.47	194
Club Subscriptions	12.48	194
Free Car-parking Facilities	12.49	194

Chapter	Paragraph	Page
Travel and Entertainment Expenses	12.50	194
Share Option Schemes	12.55	196
Income Limit	12.59	197
Discounts to Shareholders	12.62	197
Benefit-in-kind Tax	12.63	197
Recommendations	12.68	198
13. The Taxation of Capital Gains		
Introduction	13.1	201
What is a Capital Gain?	13.3	201
Present Position in Ireland	13.7	202
Capital Gains and the Concept of Income ...	13.14	203
Accrual v. Realisation	13.19	204
Inflation	13.26	206
Bunching	13.30	207
The Treatment of Losses	13.36	208
The Definition of Disposal	13.43	210
Coverage of Capital Gains Tax	13.50	211
Other Issues	13.52	212
Small Gains	13.53	212
Government Securities	13.54	212
Personal Chattels	13.55	212
Private Residence	13.57	213
Deferral of Tax	13.59	213
Roll-over Relief	13.60	214
Replacement of Business Assets	13.62	215
Compulsory Purchase	13.65	216
Disposal of a Business or Farm	13.66	216
Owner-occupied Housing	13.69	217
Companies and Capital Gains Tax	13.75	218
Conclusion	13.76	219
Recommendations	13.77	219
14. The Taxation of Development Gains		
Introduction	14.1	221
Betterment	14.3	221
Background	14.5	222
Present Position	14.9	223
The Issues	14.13	224
Taxation of Development Gains	14.14	224
The Rate of Tax	14.16	225
The Definition of Disposal	14.18	225
Identification of Development Gains	14.19	225
Conclusion	14.20	225

Chapter	Paragraph	Page
15. The Unit of Personal Taxation		
Introduction	15.1	227
Present System	15.2	227
Children	15.14	230
Other Dependants	15.17	231
Other Units	15.18	231
Conclusion	15.20	232
Recommendations	15.21	232
16. Personal Tax—Allowances and Reliefs		
Introduction	16.1	233
Married and Unmarried Persons	16.5	234
Widowed Persons	16.9	235
Child Allowance	16.13	236
Allowance for One-parent Families	16.23	240
Age Allowance and Age Exemption	16.25	241
Dependent Relative Allowance	16.28	242
Blind Persons' Allowance	16.34	244
Employed Person Taking Care of an Incapacitated Individual	16.37	244
Living Alone Allowance	16.40	245
Head of Household Allowance	16.43	245
Exemption Limits	16.45	246
Tax Credits	16.48	246
Advantages and Disadvantages of Tax Credits under a Progressive Tax System	16.52	247
Amounts of Tax Credits	16.58	248
Equivalence Scales	16.61	249
Tax and Social Welfare	16.65	251
Recommendations	16.66	251
17. The Income Tax Rate Structure		
Introduction	17.1	253
The Existing Rate Structure	17.2	253
The Reduced Rate	17.3	254
Benefit to the Lower Paid	17.7	255
Disincentive Effects	17.8	255
Higher Rates of Tax	17.12	256
Conclusion	17.13	257
Recommendations	17.14	257

Chapter	Paragraph	Page
18. Direct Expenditure Tax		
Introduction	18.1	258
Definition	18.4	258
Background	18.6	259
Sur-tax versus Progressive Income Tax Expenditure	18.9	260
Equity	18.10	260
Efficiency	18.14	261
Simplicity	18.17	262
Conclusion	18.19	262
Information Needed to Administer a Direct Expenditure Tax	18.20	262
Practical Difficulties	18.25	264
Identification of Taxpayers	18.27	265
Treatment of Assets	18.31	266
Housing	18.34	267
Loans	18.42	269
Consumer Durables	18.45	269
Antiques	18.48	270
Assessment and Collection of Tax	18.51	271
Double Taxation Relief	18.55	272
Avoidance and Evasion	18.58	272
Other Issues	18.61	273
The Tax Unit	18.62	273
Averaging	18.63	274
Emigration	18.64	274
Immigration	18.67	274
Gifts and Bequests	18.68	275
Treatment of Income Tax Payable	18.70	275
Treatment of Expenditure Tax Payable	18.71	275
Structure of the Tax	18.72	275
Transitional Arrangements	18.79	277
Recommendations	18.80	277
19. Averaging		
Introduction	19.1	279
The Problem	19.2	279
Principles	19.3	279
Background	19.4	279
Averaging for Farmers	19.7	280
Systems of Averaging	19.13	282
Tax Reserve Certificates	19.14	283
Block Averaging	19.15	283
United States System	19.18	284

Chapter	Paragraph	Page
Recommended System	19.20	284
Scope of Averaging Provisions	19.21	284
Length of the Averaging Period	19.23	285
Adjustment for Inflation	19.24	285
Recommendations	19.30	287
20. Indexation of Personal Taxation		
Introduction	20.1	288
Automatic Stability	20.3	288
Inflationary Expectations	20.7	289
Effect on Public Finances	20.9	289
Technical Problems	20.17	291
The Choice of Index	20.18	292
The Case for a General Index	20.19	292
The Price of Gross Domestic Product at Factor Cost	20.20	292
Index of Average Earnings	20.23	293
Consumer Price Index	20.24	293
The Effect of Indirect Taxes and Subsidies	20.26	294
Changes in Prices Resulting from Changes in the Terms of Trade	20.30	295
Timing of Adjustments	20.33	296
Implications for Budgetary Policy	20.35	296
Recommendations	20.37	297
21. Social Insurance Contributions		
Introduction	21.1	298
Definition of Social Security	21.3	298
Social Insurance Contributions	21.5	299
Prospective Developments	21.7	299
Social Insurance Contributions: Tax or Insurance Premiums?	21.9	300
Incidence of Social Insurance Contributions	21.16	302
Equity	21.22	303
Varying Rates of Contributions	21.23	304
Inadequate Base	21.25	304
Regressivity of Contributions	21.27	305
Efficiency	21.28	305
Simplicity	21.30	306
Evaluation of Social Insurance Contributions	21.32	306
Options for Reform	21.34	307
Social Insurance Fund	21.35	307
Earmarked Taxes	21.36	307

Chapter	Paragraph	Page
A Social Security Tax	21.37	308
Contribution Conditions	21.39	308
Tax Relief for Social Security Tax	21.40	308
Basis of Assessment and Collection of Social Security Tax	21.43	309
Rate of Tax	21.44	309
Conclusion	21.45	309
Recommendations	21.46	310
Reservation by Mr. Daniel Murphy		310
22. **Assigned Revenues**		
Introduction	22.1	312
Earmarked Taxes	22.2	312
Health Contributions	22.6	312
Eligibility for Health Services	22.8	313
Historical Background	22.9	313
Collection Arrangements	22.12	314
Conclusion	22.19	316
Youth Employment Levy	22.20	316
Recommendations	22.23	316
23. **Negative Income Tax**		
Introduction	23.1	318
Definition	23.3	318
Background	23.6	319
Objectives	23.12	320
Evaluation of Schemes	23.16	321
Conclusion	23.18	322
Recommendation	23.21	323

PART IIB

THE TAXATION OF BUSINESS, CORPORATE AND INVESTMENT INCOME

Chapter	Paragraph	Page
24. **The Justification for Company Taxation**		
Introduction	24.1	327
Relationship between Company and Shareholders	24.2	327
Limited Liability	24.10	329

Chapter	Paragraph	Page
Retained Profits	24.11	329
Conclusion	24.12	329
25. **Present System of Company Taxation in Ireland**		
Introduction	25.1	331
General Basis of the Tax Charge	25.2	331
Computation of Profits	25.3	331
Basis of Assessment	25.5	332
Rates of Tax	25.6	332
Distributions	25.8	333
Payment of Corporation Tax	25.12	333
Groups and Consortia	25.13	333
Close Companies	25.15	334
Participators and Associates of Close Companies	25.17	334
26. **The Determination of Business Income**		
Introduction	26.1	336
The Going Concern	26.3	336
Accounting Objectives	26.4	337
Historical Cost Accounting	26.6	337
Current Cost Accounting	26.15	340
Current Purchasing Power Accounting ...	26.20	341
Essential Features of Accounting System Used for Tax Purposes	26.22	342
Conclusion	26.23	343
CCA Versus CCP	26.25	343
Stocks	26.38	345
Basis of Adjustment	26.48	348
Monetary Assets and Liabilities	26.53	349
Depreciation	26.57	350
Basis of Allowances	26.62	352
Qualifying Expenditure	26.70	353
Land	26.73	354
Buildings	26.74	354
Lessors and Occupiers of Industrial Buildings	26.77	355
Allowances on Second-hand Industrial Buildings	26.79	355
Motor Vehicles	26.82	356
Asset Lives	26.84	356
Losses	26.85	356
Recommendations	26.88	357

Chapter		Paragraph	Page
27.	**Taxation of Company Income**		
	Introduction	27.1	359
	The Corporate Sector	27.3	359
	Systems of Company Taxation	27.6	360
	Desirable Attributes of a General System of Company Taxation	27.8	361
	Neutrality	27.9	361
	Distribution of Company Profits	27.14	362
	Quality of Investment	27.18	363
	The Volume of Private Savings	27.23	364
	Raising of New Funds by Companies	27.25	365
	Considerations of Equity	27.29	367
	Effect on Investment	27.30	367
	Criticisms of Present System	27.31	367
	Recommended System	27.33	368
	Evaluation of Proposed System	27.34	368
	Recommendations	27.35	368
28.	**Other Aspects of Company Taxation**		
	Introduction	28.1	369
	The Rate of Company Taxation	28.2	369
	Advance Corporation Tax	28.4	369
	Payments of Tax by Companies	28.10	371
	Transitional Arrangements	28.12	372
	The Taxation of Small Companies	28.14	372
	The Taxation of Closely-held Companies	28.18	373
	Recommendations	28.24	375
29.	**International Aspects of Company Taxation**		
	Introduction	29.1	376
	International Requirements	29.2	376
	Double Taxation	29.3	376
	Elimination of Double Taxation	29.6	377
	Subsidiary Company Operation	29.10	378
	Irish Dividends under the Partial Imputation System	29.12	378
	Double Taxation Arrangements and Ireland's Tax Incentive Schemes	29.15	379
	Change to Full Imputation System	29.16	379
	EEC Obligations	29.18	379

Chapter		Paragraph	Page
30.	**Aspects of The Taxation of Financial Institutions**		
	Introduction	30.1	381
	Background	30.2	381
	Banks	30.6	382
	Role of the Central Bank	30.8	383
	The Incidence of Bank Taxation	30.10	383
	Liquidity Ratios as a form of Taxation	30.13	384
	Special Bank Levies	30.19	385
	Tax-related Lending	30.22	386
	Conclusion	30.32	389
	Withholding Tax on Distributions	30.33	389
	Building Societies	30.35	389
	Recommendations	30.37	390
31.	**Income from Self-employment**		
	Introduction	31.1	391
	Definition	31.2	391
	Company and Personal Taxation	31.3	391
	Basis of Assessment	31.5	392
	Transitional Provisions	31.12	394
	Deduction of Expenses	31.15	395
	Restriction of Schedule D Expenses	31.19	396
	Payment of Tax	31.25	398
	Provisional Payments of Tax	31.30	399
	Amount of Tax Payable	31.35	400
	Rates of Interest	31.38	401
	Period of Grace	31.42	402
	Rates on Business Property	31.43	402
	Recommendations	31.44	402
32.	**Farming Profits**		
	Introduction	32.1	404
	Agriculture in the Irish Economy	32.2	404
	The Issues	32.3	404
	The Determination of Farming Income	32.4	404
	Present System of Valuing Stock	32.6	405
	Trading Stock	32.8	405
	Breeding Stock	32.9	406
	Incentives to Increase the National Herd	32.10	406
	Exemption of Certain Farmers from Income Tax	32.11	406

Chapter		Paragraph	Page
	Rates on Land	32.12	407
	Resource Tax	32.20	409
	Production Unit Accounting	32.24	410
	Conclusion	32.37	412
	Arrangements for Payment of Tax	32.38	413
	Recommendations	32.39	413
33.	**Investment Income**		
	Introduction	33.1	414
	Definition	33.2	414
	Assessment of Tax on Investment Income	33.3	414
	Schedule C	33.4	415
	Schedule D — Case III	33.5	415
	Rental Income	33.6	415
	Schedule F	33.7	415
	Basis of Assessment	33.8	416
	Payment of Tax	33.9	416
	Investment Income Surcharge	33.10	416
	Recommendations	33.22	420

PART IIC

THE TAXATION OF CAPITAL AND CAPITAL TRANSFERS

Chapter		Paragraph	Page
34.	**The Taxation of Gifts and Inheritances**		
	Introduction	34.1	423
	Justification for Taxing Gifts and Inheritances	34.2	423
	Historical Background	34.4	423
	Capital Acquisitions Tax	34.6	424
	The Issues	34.10	425
	The Unit of Taxation	34.11	425
	Relief for Productive Assets	34.16	426
	Assets Which Are Not Readily Realisable	34.23	428
	Agricultural Land	34.24	428
	Fragmentation	34.31	429
	Rate of Tax on Gifts	34.32	430
	Exemption Threshold	34.35	430
	Reliefs for Consanguinity	34.40	431
	Other Matters	34.45	433
	Payment of Tax with Government Securities	34.46	433

Chapter		Paragraph	Page
	Inflation	34.47	433
	Small Gifts	34.49	434
	Conclusion	34.50	434
	Recommendations	34.51	434
35.	**Annual Wealth Tax**		
	Introduction	35.1	436
	Submissions	35.3	436
	The Case for a General Tax on Capital	35.4	437
	Equity	35.5	437
	Efficiency	35.12	438
	Simplicity	35.15	439
	Conclusion	35.16	439
	Recommendation	35.17	439
36.	**Taxes to Alter the Distribution of Wealth**		
	Introduction	36.1	440
	The Distribution of Wealth in Ireland	36.2	440
	Sources of Inequality	36.5	441
	Types of Taxes	36.8	441
	Wealth Tax	36.10	442
	Taxes on Transfers of Capital	36.13	442
37.	**The Taxation of Trusts**		
	Introduction	37.1	447
	Definition	37.2	447
	Principles	37.3	447
(i)	Income Tax	37.5	448
	Taxation of Beneficiaries	37.8	448
	Deductions	37.9	449
	Trusts in Favour of Children	37.10	449
	Surcharge on Trust Income	37.11	449
	Conclusion	37.12	449
(ii)	Capital Gains Tax	37.13	450
	Settlor	37.14	450
	Trustees	37.16	450
(iii)	Capital Acquisitions Tax	37.19	451
	Trusts Other than Discretionary Trusts	37.20	451
	Discretionary Trusts	37.22	451
	Recommendations	37.25	452

PART III

IMPLEMENTATION OF PROPOSALS

Chapter		Paragraph	Page
38.	**Implementation**		
	Introduction	38.1	457
	The Single Rate of Income Tax	38.4	457
	Interlocking Recommendations	38.5	458
	Phase One	38.6	458
	Extension of the Income Tax Base	38.7	458
	Lump Sum Receipts and Other Windfalls ...	38.9	459
	Reform of Personal Income Tax Structure ...	38.10	459
	Reduction in Income Tax Rates	38.11	460
	Reform of Capital Gains Tax	38.14	460
	Reform of Corporation Tax	38.16	461
	Reform of Capital Acquisitions Tax	38.18	461
	The Adjustment of Taxes for Inflation ...	38.19	462
	Reform of Social Insurance Contributions ...	38.20	463
	Phase Two	38.21	463
	Phase Three	38.25	463
	Direct Expenditure Tax	38.26	464
	Relief for Savings Made before the Transition	38.34	465
	The Total Assets Method	38.39	466
	The Net Assets Method	38.41	467
	The Credit Method	38.43	467
	Conclusion	38.44	467
	The New System	38.46	468
	Observations and Reservations by Mr. Daniel Murphy and Mr. Donal Nevin		469
	Reservations by Mr. Donal Murphy		476
	Note on Reservations by Mr. Donal Murphy		481
	Reservation by Mr. Patrick P. O'Neill		483
	Reservation by Mr. Raymond O'Neill, S.C.		484

APPENDICES

Appendix		*Page*
1.	List of Submissions	487
2.	Official Bodies who Assisted the Commission	493
3.	List of Commissioned Work	495
4.	Incidence of Taxation — International Experience	496
5.	Taxation and the Distribution of Income	498
6.	Estimates of Income Exempted under Various Headings in 1981/82	510
7.	Local Authority Housing	511
8.	Savings in Ireland: Economic Background	515
9.	The First Home Mortgage Interest Rebate in New Zealand	519
10.	Capital Gains Tax	520
11.	Treatment of Development Gains in other Countries ...	523
12.	Rates of Direct Taxation and of Social Insurance Contributions and Benefits in Ireland	527
13.	The Purpose of Personal Allowances	530
14.	Equivalence Rates Applies or Proposed in Various Countries	534
15.	United States System of Averaging	535
16.	The Social Security System	537
17.	Company Taxation in Ireland	548
18.	Statement of Standard Accounting Practice No. 16 (Part 3)	551
19.	Current Purchasing Power Accounting	557
20.	Depreciation of Assets for Tax Purposes	564
21.	Disposal of Fixed Assets: Examples of Calculation of Charges/Allowances	571
22.	Losses Carried Forward	572
23.	The Tax Treatment of Incorporated and Unincorporated Entities	574
24.	Tax-related Lending	578
25.	Taxation of Farming Profits: Historical Background ...	581
26.	Agriculture in the Irish Economy	588
27.	Systems of Valuation of Farming Stock for Tax Purposes ...	594
28.	The System of Capital Taxation in Ireland Prior to 1975 ...	598
29.	Capital Acquisition Tax	604
30.	Wealth Tax	611
31.	The Distribution of Personal Wealth in Ireland	614

LIST OF TABLES
(in body of Report)

Table	*Title*	*Page*
1.	Shares of Agriculture, Industry and Services Sectors in Employment and in Gross Domestic Product ...	71

Table	Title	Page
2.	Consumer Price Index — All Items. Annual Percentage Changes	72
3.	Public Expenditure and Receipts as Percentage of Gross Domestic Product	72
4.	Exchequer Debt Interest	73
5.	Functional Composition of Public Expenditure: Current and Capital	74
6.	Structure of Taxation in Ireland	75
7.	International Tax Comparisons OECD Countries 1979 as a Share of Gross Domestic Product	76
8.	International Tax Comparisons OECD Countries 1979 as a Share of Total Tax Revenue	77
9.	Increase in Income Tax Liability in Ireland at 1981/82 Rates of Tax if Total Income Increased by 10 per cent	106
10.	Effect of Inflation of 10 per cent on a Married Couple at 1982/83 Rates of Tax	108
11.	Effect of Imposing 30 per cent Capital Gains Tax with No Allowance for Inflation where Capital Appreciates at the Same Rate as Inflation	111
12.	Capital Formation in Housing	130
13.	Comparison of Tax Treatment of Renter, Equity Owner and Mortgage Owner of House	131
14.	Effect on Tax Rebate on Income of Representative Households While Absent from Work in the Tax Year 1981/82	140
15.	Changes in the Stock of Assets of Irish Companies for Life Assurance Business in 1980	176
16.	Fringe Benefits 1975-81	183
17.	Company Cars by Salary Level	187
18.	Benefit of Preferential Loan to Employee	189
19.	Typical Costs of Moving House 1981	217
20.	Cash Benefit in 1982/83 from Income Tax and Social Welfare Child Allowances	237
21.	Tax Payable Under Quotient System at 1981/82 Rates	238
22.	Marginal Rates of Income Tax 1981/82	255
23.	Number of Taxpayers at Different Marginal Rates of Income Tax 1981/82	256
24.	Assessment Form for Comprehensive Direct Expenditure Tax	263
25.	Hypothetical Incomes of Farmer and Shopkeeper ...	281
26.	Comparison of Tax Treatment of Farmer and Shopkeeper with Equal Incomes	282
27.	Combined Marginal Rates of Tax and Social Insurance Contributions for Single Persons 1981/82 Rates of Tax	306

Table	Title	Page
28.	Number of Companies having a Share Capital on the Register, except Those in the Course of Liquidation or Removal from the Register	359
29.	Assessments Made to Corporation Tax	360
30.	Combined Effective Rates of Corporation Tax and Income Tax at 1981/82 Rates on Retained and Distributed Profits	363
31.	Combined Rate of Company and Personal Income Tax under Present System by Shareholders' Marginal Rate of Tax and Proportion of Profits Retained	366
32.	Funds Raised by Non-Governmental Bodies through Issues of Marketable Securities on the Domestic Capital Market	366
33.	Due Dates for Payment of Corporation Tax	372
34.	System of Company Taxation in EEC Countries ...	380
35.	Liquidity Ratios	384
36.	Internal Rates of Return to Banks on Certain Lending Transactions	388
37.	Examples of Assessment under Schedules D and E ...	394
38.	Value of Property Subject to Capital Acquisitions Tax Transferred by Gift or Inheritance	430
39.	Rates of Charge for Inheritance Tax 1981	432

List of Tables
(in Appendices)

Table	Title	Page
5.1	Distribution of Total Income for Income Tax Purposes	499
5.2	Distribution of Income and Tax Payable by Marital Status 1979/80	500
5.3	Distribution of Income and Income Tax 1979/80 by Main Income Source	500
5.4	Share of Income and Income Tax 1979/80 by Main Income Source	501
5.5	Distribution of Personal Income 1979/80	501
5.6	Components of Personal Income: Ireland	503
5.7	Percentage of Gross Income Paid in Taxes: All Households 1973	505
5.8	Total Taxes as a Percentage of Gross Income Paid in Taxes: All Households by Size 1973	506
5.9	Total Taxes as a Percentage of Gross Income of All Households by Livelihood Status of Head of Household 1973	507

Table	Title	Page
5.10	Total Taxes as a Percentage of Gross Income of Urban and Rural Households 1973	508
5.11	Total Taxes as a Percentage of Gross Income of All Households by Household Tenure 1973	509
7.1	Calculation of Differential Rents	512
8.1	Investment and Growth 1960-1980	516
8.2	National Savings 1970-1981	517
16.1	Contribution Conditions for Social Insurance Benefits	543
16.2	Contribution Conditions for Social Insurance Benefits	544
16.3	Sources of Income of the Social Insurance Fund ...	544
16.4	Sources of Income of the Occupational Injuries Fund ...	545
16.5	Sources of Income of the Supplementary Unemployment (Wet Time) Fund	545
16.6	Financing of Social Assistance Services	545
16.7	Financing of All Social Welfare Services	546
19.1	Historical Cost Accounts for Year ended December, 1981	562
23.1	Comparison of Tax Payable by Incorporated and Unincorporated Entities	575
26.1	Agriculture and Industrial Product as a Percentage of Gross National Product at Factor Cost 1971-1980 ...	589
26.2	Workforce in Agricultural, Industrial and Service Sectors as a Percentage of the Total Labour Force at Mid April 1975-1980	590
26.3	Analysis of Farmers by Age and Acreage	591
26.4	Annual Capital Investment by Category 1973-1980 ...	591
26.5	Changes in Income Arising in Agriculture 1970-1980 ...	592
26.6	State Expenditure in Relation to Agriculture 1973-1980	593
28.1	Rates of Estate Duty in 1975	600
28.2	Amount of Duty Payable in Certain Cases on an Estate of £50,000	603
31.1	Distribution of Personal Wealth in Ireland 1965/66 ...	614
31.2	Distribution of Personal Wealth in the United Kingdom, 1976	615

INTRODUCTION

1. The decision by the Government to appoint a Commission on Taxation was announced in a statement issued on behalf of the Minister for Finance by the Government Information Services on 28 March, 1980. The Commission was established with the following terms of reference:

> "To enquire generally into the present system of taxation and to recommend such changes as appear desirable and practicable so as to achieve an equitable incidence of taxation, due attention being paid to the need to encourage development of the national economy and to maintain an adequate revenue yield; and to provide interim reports on such matters as the Commission considers desirable or as may be referred to it by the Minister for Finance for specific consideration".

2. In an address to our first meeting on 14 April, 1980, the Minister for Finance, Mr. Michael O'Kennedy T.D., made it clear that the terms of reference were very broad and suggested that we establish certain priorities for our examination of the taxation system. He did not think it appropriate to say what these priorities should be, this being a matter for us to decide, but commented generally on the problems of taxation as the Government saw them. The Minister asked us to take account of:

(i) The level of taxation needed to provide the services that are required.

(ii) The desirability of a more equitable personal income tax system.

(iii) The need to examine the relationship between taxes on income and on capital.

(iv) The need to examine the relationship between income tax and social insurance contributions.

(v) The contribution to taxation made by companies, and

(vi) The possibility of improving the administration of the tax code.

Our Approach

3. Having examined the existing tax system and having taken account of the views expressed in the submissions received, we have set out in this report the principles on which taxation should be based and how these

principles should be applied in the case of direct personal, corporate and capital taxation.

4. Our recommendations in this report are designed to establish a basic system of taxation which is equitable and relatively simple. This structure is flexible enough in its detailed operation to adjust to changes dictated by political decisions of Government. Such flexibility is essential if the system is to last for a long period of time, as we believe it can.

5. Adjustments to this system for purposes of general economic management will be required. These will be in the form of incentives or disincentives provided on a temporary basis and designed to influence economic behaviour. We will deal with this question in a later report. Other matters which we propose to consider include indirect taxation, the machinery of taxation, local taxation and the taxation of charities. The question of the balance between direct and indirect taxation must also be dealt with.

6. We have examined estimates of the revenue and income distribution effects of our proposals. We are satisfied that our recommendations are feasible. We will continue to keep this aspect of our work under review.

7. Addressing our first meeting, the Minister for Finance indicated that we should consider the feasibility of submitting interim reports on certain topics. In this context, he mentioned specifically the taxation of farmers and financial institutions. The first of these subjects is examined in this report against the general background of the taxation of self-employed persons. The departures from the proposed general system which may be required to achieve improved efficiency and output in farming will be dealt with in a later report.

8. On the question of the appropriate tax treatment of financial institutions, we concluded that it would be undesirable to publish a comprehensive study of this special area without first considering the general principles which should underpin the direct tax system as a whole. Existing levies on financial institutions are examined here however, in the context of the taxation of company income. We also consider tax-related lending to the extent that it affects the taxation of bank profits.

9. Our main proposals and the major considerations which informed them are outlined in "The Key Elements of Proposed Reforms" which follows this introduction. This is followed by a list of our specific recommendations.

Method of Work

10. At our first meeting we decided to invite the public to make written submissions. We advertised in the national morning papers on 18 April and

5 May, 1980 inviting submissions by 30 June, 1980. Individual letters specifically inviting submissions were addressed to a range of national organisations (including all registered political parties), trade unions and trade groups which might be expected to have a direct interest in our work. Many of those approached took advantage of the opportunity offered to make representations. A full list of submissions is published in Appendix 1. While a substantial number of submissions was received by 30 June, 1980, their flow continued throughout 1980, 1981 and almost up to the date of publication of this report.

11. We did not consider it necessary to request all those who made submissions to appear before us in support of their written opinions. To have requested a meeting in each case would have imposed an unnecessary burden on the time of the organisations and individuals concerned and would have unduly prolonged our review. We did, however, invite a number of people to meet us where we thought a discussion would be of assistance. We also consulted widely on an informal basis with a large number of individuals both at home and abroad. These consultations were very valuable in developing our understanding of the problems we had to consider. A list of official bodies who helped us is set out in Appendix 2.

12. Continuous contact was maintained with the Office of the Revenue Commissioners and the Department of Finance. Other Government Departments and the Central Statistics Office were asked to provide background information or comment on aspects of our work which we considered relevant to them. The Department of Foreign Affairs helped in arranging contacts abroad and obtaining necessary information and literature.

13. On certain aspects of our investigations where specialist research was necessary we commissioned studies and sought specialist advice to supplement the work done by our own secretariat. A list of these studies and their authors is given in Appendix 3.

14. The Chairman of the Commission and members of the secretariat paid visits abroad to discuss certain aspects of taxation with officials from Governments and other organisations and experts in various fields. Visits were made to the United Kingdom, Belgium and France.

15. We met formally on 38 occasions in the preparation of this report. All meetings were held in Dublin.

Construction

16. Taxation is paid by people and a tax system applies to people. To avoid the continual use of awkward constructions such as "his/her" or "her/his", the words "he", "his", and "him" are used throughout this

report for both sexes whenever the sex of the person in question is of no consequence for the discussion. It is not implied that tax provisions apply only to men; the term "he" is used to embrace both male and female.

Acknowledgements

17. We have mentioned the large number of persons and agencies who helped us in so many ways. These include those who made submissions, those with whom we held formal and informal discussions and, of course, those departments and offices of the State we contacted on a regular basis. We would like to take the opportunity here of expressing our initial thanks and our hope that this co-operation will continue for the duration of the remainder of our work.

18. The contribution of the secretariat, in terms both of the quality and volume of work, has been outstanding. The Secretary, Donal de Buitléir, and the other members of the secretariat have enabled the Commission to adhere to a timetable and achieve a result which is quite remarkable. On our own behalf and on that of all those whom this report will serve we are grateful.

THE KEY ELEMENTS OF PROPOSED REFORMS

Introduction

1. This report deals with the general system of direct taxation which we consider should apply in Ireland. We have been set the task of devising a system which is equitable, contributes to economic progress and is relatively simple. These requirements can conflict. However, because the existing system is unfair, muddled and complicated, we have been able to make recommendations which offer substantial improvement on all counts. In cases in which the requirements of equity, efficiency and simplicity have come into conflict, we have had to make judgements on the proper weight to give to each. However, in our recommendations the spirit of equity is the first and most important consideration. Departures from equity must be clearly justified by reference to the needs of economic development or to avoid imposing unreasonable compliance costs on individuals or high administrative costs on the Revenue Commissioners.

2. The key elements of the taxation system we propose are:

   (i) Income tax should remain the main source of direct taxation in Ireland.

   (ii) Income tax should be charged at a single rate on all income arising in the personal and corporate sectors.

   (iii) The single rate of income tax should be lower than the current standard rate and should apply to a much more equitable and comprehensive definition of income than at present, including wages, salaries, profits, realised capital gains, lump sum receipts, gifts, inheritances and other windfalls.

   (iv) The extraordinary range of exemptions and deductions from income for tax purposes which narrow the tax base and result in higher tax rates should be abandoned. Only standard personal allowances given in the form of tax credits should remain.

   (v) The essential redistributive function of the tax and public expenditure systems should be achieved through direct payments at the bottom of the scale, through the choice of a level of personal credit

and the tax rate in the middle income range and the imposition of a progressive direct tax on expenditure at the top of the scale.

(vi) Social insurance contributions should be replaced by a social security tax levied at a single rate on all income as we define it, including realised capital gains and taxable gifts and inheritances.

(vii) The tax system should be adjusted systematically to deal with the distortions arising from inflation through indexation of progressive tax structures and capital/income adjustments to take account of changes in the real value of liabilities and income-producing assets.

(viii) Tax borne at the company level should be available for imputation in full to the shareholder when distributions are made out of the underlying profits.

(ix) The different treatment of individual and family for income and capital tax purposes should be replaced by uniform treatment in which the family is the basic unit.

3. These proposals constitute a formidable programme of tax reform which could not be carried through easily or in a short time. Many of the individual recommendations may be opposed. However, tax reform is a collection of measures, each of which affects some individuals adversely and others favourably. Those who will not benefit are those who are over favourably treated under the existing system. Our recommendations are interlinked; the advantageous cannot be demanded while the unpalatable are rejected. We believe that the total package represents a practicable and desirable measure of tax reform. The end result will be a more equitable system which will be less complicated than the present system and will contribute to greater economic efficiency and social progress.

The Income Tax Base

4. The major defect of the existing system of direct taxation in Ireland is that there is no definition of the income tax base in our tax code. What is regarded as income follows from judgements laid down by the Courts over many years. The *de facto* definition of income which has evolved as a result is not clear, consistent or coherent. It also facilitates avoidance.

5. We believe that the direct tax base should be defined on a basis which measures the amount which a person could spend in a particular period, while maintaining the real value of his capital intact in terms of general purchasing power. Such a tax base embraces all accretions of economic power including capital gains, gifts, inheritances and other windfalls. We do not believe it matters, from the point of view of taxation, whether an accretion is earned through working, gained from operating a business, received as a return from property, gained from selling property or received

as a gift. It does not matter whether the accretion is expected or unexpected, whether it is in cash or in kind, whether it is received in return for work or gratuitously or whether it is regular or irregular.

6. It is important to underline that we define the tax base in real terms. The distorting effects of inflation on taxation must be tackled systematically. This requires the indexation of all progressive tax structures and adjustments to the tax base to ensure that only real accretions of capital are taxed as income. To compensate some sectors for inflation and not others would give rise to unacceptable inequities between taxpayers and would distort the allocation of resources, thereby making us all poorer. The adjustments necessary to deal with inflation increase the complexity of the system. However, they are essential unless taxation is to be wholly unfair and to hinder the efficient working of the economy.

7. The adoption of a comprehensive tax base has made our task relatively easy. From it we have concluded that much of income which at present is excluded from taxation should be brought into charge and that many existing reliefs should be terminated. For example, we recommend that all social welfare benefits, compensation payments for loss of office, redundancy payments, lump sum retirement benefits, artists' earnings and gambling winnings should be charged to tax. We also recommend that the tax deduction for certain interest, life assurance and medical insurance premiums be withdrawn. Some further implications of the comprehensive tax base are drawn out below.

Fringe Benefits

8. We have paid particular attention to the taxation of fringe benefits. Income in the form of benefits-in-kind should bear the same amount of tax as would its equivalent in the form of money, if paid directly to the recipient.

9. We recommend that fringe benefits be charged on the basis that the market value of property, services or facilities furnished by an employer in connection with the performance of services must be included in the recipients' gross income. "Market value" generally is the amount that the recipient would have to pay in an arm's length transaction to purchase the same or an equivalent item or its use. Exceptions need to be provided from this general rule in respect of working conditions and for reasons of administrative convenience.

Taxation of Borrowings and Savings

10. The tax treatment of borrowing in Ireland is generous compared with the tax treatment of savings. Interest rates are low relative to the prevailing

rate of price inflation. Real interest rates have generally been negative for some years. Other things being equal, this can be expected to encourage borrowing and discourage savings.

11. The personal sector also enjoys significant inducements to borrow. However, the taxation of savings is penal. The amounts of nominal interest which can be earned tax-free on most deposits is £140 per year for a married couple. Levying tax on nominal interest earnings rather than on real interest earnings is a discriminatory tax on certain forms of capital and creates strong disincentives to some forms of saving in an inflationary environment. Other forms of savings such as life assurance premiums, retirement annuities or contributions to approved superannuation funds qualify for a greater measure of tax relief.

12. The structure of reliefs and exemptions in respect of savings has been built up over a number of years in pursuit of a variety of objectives and is now extremely complex. Equity and efficiency are likely to be best served if the existing distortions in the savings market, introduced by differential tax treatment, were eliminated. Our proposals involve a substantial move in this direction.

13. We conclude that the overall balance in Ireland is heavily weighted towards borrowing and against saving. This imbalance needs to be rectified. This should be achieved by reducing the tax reliefs for borrowing and increasing those for saving. Such a policy, in addition to improving the equity of the tax system, would also lead to improvements in economic efficiency as the distortions which result from the present system were eliminated.

The Tax Treatment of Housing

14. We have considered in some detail the tax provisions which apply to housing. The market for dwelling houses is distorted by many interventions by Government (including special tax provisions). The tax provisions in relation to the acquisition and owner-occupation of housing are very favourable. We believe that these have increased the price of housing, as well as the proportion of investment going to certain types of housing not related to needs. In addition to being a necessity of life, housing is regarded widely as an investment medium, providing one of the best hedges against inflation. We consider that this perception of housing under our present system has been accurate.

15. If we were to deal with housing by strictly applying our definition of income, owners would include rent (or imputed rent in the case of owner-occupiers) and real capital gains, less real interest and maintenance costs, in their income for tax purposes. This scheme would be neutral in its

treatment of housing investment relative to other forms of expenditure, and would improve the utilisation of the existing housing stock. We recommend this scheme in all cases except that of a principal residence.

16. In the case of a principal residence, we do not suggest imputing a rental income. However, we do recommend that mortgage interest payments should no longer be allowable generally as a deduction from income for tax purposes. This would reduce the distortions in the existing housing market.

17. We consider that the encouragement of owner-occupation is desirable, but State aid to home buyers needs to be made more selective and concentrated on first-time home buyers. To improve equity and efficiency in housing, we recommend that the deduction for mortgage interest be replaced by a scheme which would concentrate State aid on first-time purchasers of houses during the early years of their mortgage, which is the period in which they require most help.

18. We have also considered giving a deduction for rent paid. This would lead to a more efficient market for housing (equivalent to imputing the rental income of owner-occupiers). We are convinced that this would unduly narrow the tax base and favour housing relative to other expenditure and we decided against it. If it were desired to equalise the tax treatment of owners and renters, this should be done by imposing additional taxation on owners rather than by reducing it on renters.

19. None of the above considerations affects our conclusion that realised capital gains in real terms on all housing should be charged to tax.

The Treatment of Capital Gains

20. Capital gains come within our concept of income and should be taxed as such. However, it is not possible to charge capital gains to tax as they accrue without creating severe problems for both taxpayers and the Revenue Commissioners. For this reason, we propose that such gains should only be charged when they are realised. We consider that only real gains can properly be treated as income. As a result, nominal gains need to be deflated by a suitable price index — in our view the Consumer Price Index — to determine the taxable gain.

21. We consider that development gains require special treatment. These are gains which arise primarily from the provision of infrastructural services financed by the community or from community decisions allowing development to take place in some areas but not in others. In principle, all such gains should accrue to the community in full. The proper method of ensuring this has been the subject of study by a number of bodies. It is a highly complex area. We content ourselves with outlining a possible scheme

to obtain some of the benefit involved for the taxpayer if it should be decided that taxation measures are an appropriate and efficient method of doing so.

Personal Tax Allowances and Reliefs

22. We consider that all personal tax allowances should be converted into tax credits. We do so for three main reasons. Firstly, under a progressive system, if allowances for all items other than the single and married personal allowances are given in the form of credits, the effective amount given to all taxpayers is the same. Secondly, a change to credits would enable a reduction to be made in marginal rates of tax while maintaining the same progression of the tax structure; this would be a simpler and clearer alternative. Thirdly, if the single and married allowances are also given as credits the system is simpler to administer and easier to understand.

23. We believe that the most effective and efficient method of helping the poor is not to exempt them from taxation but to ensure, by means of direct transfer payments or other measures, that they have an adequate income. The tax system cannot be used to help people who have little or no income — those who need help most. The sole purpose of tax credits should be to achieve equity between persons with the same income but different dependency and other obligations, and not to exempt a minimum or subsistence income from taxation. In principle, therefore, the credit for single persons could be set at any level and the level of all other credits fixed to ensure that the relative tax payable by other categories is satisfactory in relation to single people.

24. We have also considered the allowances and reliefs now available in the personal income tax code. In many cases they seem a partial solution to problems which would be better dealt with through the social security system in ways which give equitable treatment to taxpayer and non-taxpayer alike. This applies particularly to the income tax child allowance which we recommend should be integrated with the social welfare child allowance and paid at a flat-rate in respect of all children.

Indexation of Personal Taxation

25. We recommend that any tax credits, thresholds or bands of taxable income be indexed annually in line with movements in the Consumer Price Index. This does not mean that Government is committed irrevocably to unchanged taxes in real terms. Indexation is purely a technical procedure to ensure that decisions to increase or decrease the tax burden or to change its distribution are taken explicitly, rather than allowed to occur unnoticed. Government would retain full discretion over taxation but should present changes in policy against the background of the indexed system.

Single Rate of Income Tax

26. We have recommended that tax be charged at a single rate on ordinary income, realised capital gains and gifts and inheritances. This has very great advantages. It enables the tax base to be expanded. The tax system is then neutral between income gains and capital gains, thereby allowing significant simplification and reducing the scope for tax avoidance. It is neutral also between incorporated and unincorporated businesses and between the retained and distributed profits of companies. A single rate of income tax at a relatively low rate would enable capital to be accumulated by individuals out of earnings for investment purposes. When set against these advantages, it is clear that the price to be paid for having a nominally progressive income tax schedule is high, without such a system achieving very much in the way of redistribution because the tax base is so narrow.

Direct Expenditure Tax

27. The main disadvantage with charging income tax at a single rate is that it removes the major progressive element in the tax system. We believe that an acceptable degree of progressivity can be brought into the tax system by means of a sur-tax on expenditure. This would enable the advantages of charging income tax at a single rate to be retained. In these circumstances, we recommend the introduction of a direct expenditure tax at progressive rates to apply to individuals with relatively high expenditure.

28. In addition to allowing the advantages of a single rate of tax on all income, a direct expenditure tax has distinct advantages over income tax at the higher rates. A direct expenditure tax is more difficult to avoid than an income tax, since there is less scope to artificially reduce expenditure rather than income without reducing living standards. One of the main arguments for a wealth tax is that wealth confers on its holders the opportunity to consume more than their income. To the extent that this opportunity is exercised, it will be charged to expenditure tax. This achieves some of the equity objectives sought by the proponents of wealth tax without the adverse economic effects on wealth creation and investment.

Progressivity

29. We believe that equity requires a degree of progressivity in the tax and public expenditure systems. In simple terms, when all State taxes and benefits are paid and received, the better-off should be somewhat worse off and the position of the poorer sections of the community improved. We accept that only the political process can finally determine the degree of progressivity that is thought to be desirable.

30. Substantial progressivity in the system can be achieved on the expend-

iture side of the account through transfer payments to certain classes. This is the only method of achieving a degree of progressivity likely to be acceptable at the lower end of the scale. The direct tax system must, however, be capable of imparting some progressive bias to the system, particularly at the higher end of the scale.

31. Many of our recommendations would increase the progressivity of the existing tax system at existing rates of tax. These include the change from allowances to credits, the abolition of many deductions and reliefs and the extension of the income tax base. Our proposals for a social security tax remove a significant regressive element from the tax code. This raises the question of the number of people who should be liable either to income tax at the higher rates or the direct expenditure tax.

32. When such estimates as can be made are examined, it appears that the present system of taxation has been approximately proportional over the middle band of income in which most people in Ireland spend most of their working lives. We believe that proportional taxation is broadly acceptable to the public at large, provided it is supplemented by progressivity towards the top of the income scale and by relief at the other extreme.

33. The number of persons liable to sur-tax for 1973/74 was about 8,000, or about 1 per cent of the total number of effectively liable taxpayers (730,000) for that year. For 1981/82 about 135,000, or 17 per cent of effectively liable taxpayers, paid tax at the higher rates. Provisional estimates for 1982/83 put the number liable at the higher rates at 315,000 or about 40 per cent of the total number of income taxpayers. The effect of the March, 1982 budget was to bring nearly 200,000 more individuals into liability at the higher rates who had previously been liable to tax at the standard rate only.

34. In our view, this situation cannot be sustained, since it is not acceptable that persons whose incomes are a little above average should be liable to tax at marginal rates in the region of 50 per cent. The contrast with the position in the United Kingdom is striking. There, only about 4.5 per cent of taxpayers were liable at the higher rates in 1981/82. We consider that our proposals to extend the income tax base and to introduce a direct expenditure tax for those at the upper end of the scale of income and wealth must result in the vast majority of taxpayers being liable at a combined income and social security tax rate below the current standard rate of income tax of 35 per cent. Not only would this allow more effective redistribution than at present but the disincentive effects of the current high marginal rates and the encouragement they provide to avoidance and evasion would be greatly reduced. Accordingly, our proposals would lead to greater certainty and stability in the whole taxation area. This would in turn facilitate the

orderly development of incomes and industrial relations policies, business and investment planning and public sector financing.

The Unit of Personal Taxation

35. The selection of the unit of taxation is one of the most difficult issues in the field of direct taxation. Should the unit be the individual, husband and wife, the family or some wider group? We consider that the tax unit should be defined in a way which reflects the manner in which society organises itself for social and economic purposes. It should recognise that people pool their resources and assume the responsibility for the care and maintenance of others. The tax code cannot take into account every individual case where incomes are shared or responsibility, whole or partial, assumed. It must therefore make certain assumptions and the obvious group about which to make these assumptions is the family. Therefore, we believe that income sharing should be assumed to exist between spouses (except where the spouses declare otherwise) and between parents and dependent children. This implies that the income of spouses and dependent children be aggregated and that taxation on an individual basis be applied in other cases. A married couple would still have an option to be assessed as single persons and in such a case we recommend that the income of dependent children should be divided equally between the spouses for tax purposes.

Social Security Tax

36. Most of us recommend that social insurance contributions be replaced by a social security tax levied on income as we have defined it, including realised capital gains and taxable gifts and inheritances. This would imply that employer contributions would be related to profits rather than payroll, while employee contributions would be a proportion of income (without a ceiling). This would make social security taxation indistinguishable from personal income and corporate taxation in its incidence and administration. However, we do suggest a continuing conceptual distinction between these taxes and the continuation of a separate fund along the lines of the existing Social Insurance Fund.

37. These proposals represent a great improvement on the existing social insurance contributions which are objectionable in many respects. They are regressive relative to income, due to the imposition of a ceiling of income above which the same absolute contribution is payable. They fail to take ability to pay into account, since the same contribution is payable without regard to marital status. Their economic effects are undesirable, resulting in a higher level of unemployment and a larger balance of payments deficit than if the same amount of revenue were raised by alternative means.

38. Our proposals also imply a reduction in employers' social insurance contributions. The burden of the social insurance contributions now levied on employers is largely shifted to consumers in the form of higher prices. In the exposed market sector, it is shifted to employees in the form of lower wages or higher unemployment. These contributions are a discriminatory tax on employment and are completely contrary to the declared national goal of achieving full employment. They also reduce the competitiveness of Irish made goods on both the home and export markets.

Assigned Revenues

39. Assigned revenues are special levies or taxes earmarked for specific purposes. In general, we are opposed to such taxes and conclude that they should be integrated with general taxation. In particular, we recommend that health contributions and the youth employment levy should be integrated entirely with income tax.

Negative Income Tax

40. Negative income taxes are schemes which involve the closer integration of direct taxation and income maintenance schemes. Any attempt to solve the problem of poverty with a single comprehensive system of income maintenance, which is integrated with the income tax system, would be very costly. The problem with negative income tax schemes is that the level of personal tax credits must be fixed at a high level of income and these must be extended to everybody. While the idea has attractions, we have concluded that negative income tax would restrict the flexibility of the system and be very costly. When resources are scarce the only method of granting an acceptable level of income to the poor is to make selective payments to them, not to give universal payments to everyone, regardless of income.

41. We believe that our approach, which involves the continued separation of direct tax and income maintenance schemes, is better than integrating the two systems. This is because it is the only method of providing an acceptable level of income maintenance. Secondly, it enables substantial simplifications to be made to the income tax code without causing further complications to income maintenance schemes. Thirdly, by lowering marginal rates of income tax across the board, poverty traps are reduced. This also has a beneficial effect on work incentives by enabling lower marginal rates of tax to be charged on the taxpayer at work than would be the case if negative income taxes were introduced.

The Taxation of Company Income

42. Under a system which taxes income on a comprehensive basis, the correct treatment in principle of income arising to companies would be to

allocate to each shareholder his share of the earnings of the company which had not been paid out in dividends. The basic idea would be to tax the company as if the shareholders formed a partnership. This is not possible in practice, particularly in the case of companies with wide share ownership. Therefore, tax should continue to be collected at the company level as a prepayment of shareholders' liability.

43. Almost all the problems in the area of company taxation arise because company profits are charged to tax at a flat-rate, while income tax on individuals is charged at progressive rates. This results in the use of companies for tax avoidance purposes. Distortions also arise because, under such a system, it is impossible for taxation to be neutral in its treatment of retentions and distributions. The present Irish system also discriminates against income taken out of companies by way of dividend rather than remuneration. It favours debt as against equity capital.

44. We recommend that tax be charged on company profits at the single rate which applies to personal income and realised capital gains. We also recommend that the rate of imputation on company dividends be increased to 100 per cent of the underlying corporation tax and that a withholding tax should be levied on company distributions. Such a system would remove all the distortions which arise under the present system of taxing company income.

The Determination of Business Income

45. Special problems arise in determining business income in periods of inflation. We believe that in computing the income arising from a business, account must be taken of the fact that the business is a going concern and will continue in operation for the foreseeable future. This implies that the profit of the business entity is the amount which remains after having maintained intact the operational capacity of the enterprise and before remunerating the providers of equity and debt capital.

46. The experience of inflationary conditions in recent years has highlighted the deficiencies of historical cost accounting. Conventional financial statements have lost much of their significance and have, in many cases, seriously distorted the perceived financial position of enterprises. By largely ignoring the effects of price changes on non-monetary items, and entirely ignoring the impact of inflation on monetary assets and liabilities, historical cost accounts fail to provide an up-to-date measure of the resources and operating results of the business entity. As a result, we consider that historical cost profit is not an appropriate basis for taxation.

47. We consider, in principle, that business income should be determined for tax purposes on a basis which maintains intact the capital employed in

the business entity. It is a matter for the accountancy profession to develop a system of accounting which achieves this result. Accountancy is in the process of evolving and developing from the traditional historical cost convention. Although an accounting standard exists which makes it mandatory for certain businesses to publish current cost accounts, there is as yet insufficient acceptance that this method is adequately tested and capable of general application. Until the evolution has reached a point at which the accounting profession has confirmed the principles and practice of current cost accounting for universal application, it would not be appropriate as a basis for taxation. However, we consider that the tax system should facilitate rather than inhibit the evolution of an improved accounting method. Our recommendations in this area are set out in Chapter 26.

Income from Self-Employment

48. There is a widespread belief that income from self-employment charged to tax under Schedule D is treated more leniently than income from employment charged under Schedule E. This arises because the basis of assessment, the arrangements for payment of tax and the rule allowing a deduction for expenses are different for the two classes of income. We find that in periods of inflation the treatment of Schedule D income is more favourable. However, other elements in the tax system weigh heavily on the self-employed. We make recommendations designed to equalise the tax burden on the two forms of income.

Farming Profits

49. In general, equity requires that the same principles of taxation should apply to farmers as to other taxpayers in so far as this is possible. Departures from the treatment implied by this principle imply inequitable treatment of farming and require specific justification. For this reason, the general structure of taxation which we recommend for self-employed persons should apply to farmers. An is the case of other sectors, we defer the question of incentives for agricultural development to a later report.

Taxation of Gifts and Inheritances

50. The main justification for gift and inheritance taxes is on equity grounds, since gifts and inheritances confer the same command over economic resources as ordinary income. This suggests that, in principle, gifts and inheritances should be taxed at the same rate as ordinary income. Departures from this approach may be justified on two grounds only. Firstly, reliefs may be required on economic grounds because of the adverse effects on production and investment which may result from imposing such a charge. Secondly, if income is charged at progressive rates on an annual basis it would clearly be inequitable to charge gifts, inheritances and

other windfalls without giving some relief due to the irregular pattern in which they occur.

51. On this basis, we conclude that gifts and inheritances should be subject to the single rate of income tax. We hold different views on whether or not there should be an exemption threshold for purposes of tax on gifts and inheritances and if so how much it should be. We see no strong case on equity grounds for any exemption threshold for amounts received by way of gift or inheritance. We are, however, agreed that the existing threshold of £150,000 for immediate relatives would be much too high in the context of our recommendations and should be substantially reduced when they are implemented.

52. We have also considered the question of reliefs on the basis of consanguinity. This implies varying the rate of tax according to the closeness of the relationship between the donor and the donee. We conclude that the case in equity for consanguinity reliefs is extremely weak. It may be felt that these proposals for the taxation of gifts and inheritances involve a heavier burden than has been traditional in Ireland. While this may be so in certain instances, our proposals must be seen in the context of our other recommendations regarding capital maintenance. In addition, the effective exemption of tax on transfers between spouses and the deferral of tax on transfers to dependent children will ensure that no hardship results from these proposals.

53. We recognise that the generally held view in Ireland is in favour of consanguinity reliefs. We hold divergent views on this question. However, it is not a major principle. We recommend, therefore,that if the case for consanguinity reliefs is conceded, the reliefs should be implemented by reducing the exemption threshold, if any, for cases in which the relationship is more distant, rather than increasing it for gifts and inheritances passing to the immediate family.

54. We have also considered difficulties which may arise from the payment of tax on productive assets in cases in which there are problems in meeting tax liabilities. We believe that this problem should be tackled by making appropriate arrangements for the spreading of tax liability rather than by introducing valuation concessions which, of their nature, tend to be reflected in increased prices of the assets in question, thereby defeating the purpose for which they were intended.

An Annual Wealth Tax

55. We have examined the case for an annual wealth tax and concluded that the taxation of capital through the imposition of comprehensive

taxation of gifts and inheritances, rather than the imposition of an annual wealth tax, is more desirable on equity and efficiency grounds. There are also substantial administrative arguments favouring this approach. The only firm basis on which a case for a wealth tax can be made is to bring about changes in the distribution of wealth.

Taxes to Alter the Distribution of Wealth

56. Information about the distribution of wealth in Ireland is defective and does not provide a satisfactory basis on which to make judgements about the need for capital taxation. However, the distribution of wealth is a legitimate concern of Government. It is for Government to decide whether intervention to secure a more even distribution of wealth would be in the community interest. Taxation is one instrument which may be used to achieve this. Should it be decided to use the tax system to bring about changes in this area, we consider that the most effective method of doing so is to introduce a progressive tax on accessions. This would be more equitable than other possible instruments and is likely to be less disruptive of economic activity.

Conclusion

57. The key elements in our proposals are:

(i) Income tax should remain the main source of direct taxation in Ireland.

(ii) Income tax should be charged at a single rate on all income arising in the personal and corporate sectors.

(iii) The single rate of income tax should be lower than the current standard rate and should apply to a much more equitable and comprehensive definition of income than at present, including wages, salaries, profits, realised capital gains, lump sum receipts, gifts, inheritances and other windfalls.

(iv) The extraordinary range of exemptions and deductions from income for tax purposes which narrow the tax base and result in higher tax rates should be abandoned. Only standard personal allowances given in the form of tax credits should remain.

(vi) The essential redistributive function of the tax and public expenditure systems should be achieved through direct payments at the bottom of the scale, through the choice of a level of personal credit and the tax rate in the middle income range and the imposition of a progressive direct tax on expenditure at the top of the scale.

(vi) Social insurance contributions should be replaced by a social security tax levied at a single rate on all income as we define it, including realised capital gains and taxable gifts and inheritances.

(vii) The tax system should be adjusted systematically to deal with the distortions arising from inflation through indexation of progressive tax structures and capital/income adjustments to take account of changes in the real value of liabilities and income-producing assets.

(viii) Tax borne at the company level should be available for imputation in full to the shareholder when distributions are made out of the underlying profits.

(ix) The different treatment of individual and family for income and capital tax purposes should be replaced by uniform treatment in which the family is the basic unit.

SUMMARY OF RECOMMENDATIONS

Chapter 3: Criteria for Tax Systems

1. A tax expenditure budget listing the cost in terms of revenue foregone of all items of tax expenditure should be published regularly.

Chapter 7: Inflation and Taxation

2. The tax system should be neutral with respect to inflation.

Chapter 10: The Widening of the Income Tax Base

3. Due to the administrative difficulties of charging the imputed rental income from housing and other durable goods, such income should continue to be exempt from tax, except in the case of houses other than a taxpayer's principal private residence.

4. Rent should not be allowed as a deduction for income tax purposes.

5. All social welfare benefits should be charged to income tax.

6. The scheme to limit the income of an unemployed person to 85 per cent of the after-tax income enjoyed in the period prior to unemployment could be terminated, if all social welfare benefits were taxed.

7. Compensation payments for loss of office should be charged to income tax in full.

8. Lump sum retirement benefits should be charged to income tax in full.

9. Lump sum payments under the Redundancy Payments Act, 1967 should be charged to income tax in full.

10. That part of compensation payments for physical or other injury which is attributable to loss of past or potential future income should be charged to income tax.

11. The exemption of certain foreign pensions paid to Irish residents under section 9 of the Finance (Miscellaneous Provisions) Act, 1968 should be repealed.

12. The exemption of the earnings of certain artists should be terminated.

13. Payments to artists under the Aosdana scheme should be charged to income tax.

14. Gambling winnings in excess of a *de minimis* figure should be charged to income tax.

15. Gambling losses should only be available for set-off against future winnings from gambling.

16. The exemption from tax of the profits of sweepstakes held under the Public Hospitals Act, 1933 should be withdrawn.

17. Medical insurance relief should be abolished.

18. Until adequate provision can be made through direct expenditure under the health services for long-term illness, health expenses relief should be retained for unreimbursed expenses in excess of £500 per annum.

19. The deduction for premiums under permanent health insurance schemes should be withdrawn and any benefits under these policies paid free of tax.

20. Relief for expenditure on residential premises should be terminated.

21. No general change should be made in the Schedule E expenses rule.

22. No change should be made to extend tax relief in respect of expenses incurred in travelling to and from work.

23. No further relief should be introduced in respect of educational expenses.

24. The additional deduction for Schedule E taxpayers should be ended when Schedule D taxpayers are put on a current year basis of assessment.

25. Interest on underpayments and overpayments of PAYE tax should run from the end of the year of assessment for which the tax was underpaid or overpaid.

26. Recognition of new covenants for tax purposes should be withdrawn from a current date. Existing covenants could be allowed to run their course. In cases in which an individual is making payments under covenant to a separated spouse, such an individual should be entitled to the married person's tax credit.

Chapter 11: The Taxation of Borrowing and Saving

27. Income from all interest-bearing deposits should be charged to tax to the extent only that the rate at which it accrues exceeds the rate of inflation during the period of accrual.

28. The gearing gain arising from the erosion of the real value of monetary liabilities should be charged to tax. As a first step towards achieving this end, the deduction for tax purposes of all interest (including house purchase) should be withdrawn. [We set out in Appendix 9 an alternative scheme of aiding first-time purchasers of houses].

29. The same treatment for tax purposes should apply to deposits with *all* deposit-taking institutions.

30. The composite rate arrangement for the taxation of interest on building society deposits should be ended.

31. The 20 per cent relief for individual investors in certain industrial companies should be ended.

32. Dividends paid out of profits which qualify for export sales relief should continue to be free of tax.

33. Any approved pension scheme should refund to an individual who is leaving an employment a lump sum equal to total contributions made on his behalf plus interest earned thereon. The refund of contributions should be charged to tax in full. If the lump sum is subsequently reinvested in some other approved pension arrangement the tax deducted should be refunded.

34. The present restrictions on the proportion of income which may be devoted to purchasing retirement annuities discriminate against self-employed persons and should be brought into line with those applying to employees.

35. As an alternative to approved pension schemes and retirement annuities, the use of individual retirement accounts on the lines set out in paragraph 11.60 should be considered.

36. Income tax relief in respect of life assurance premiums should be withdrawn and such premiums governed by the same provisions as other forms of saving.

37. Income from national savings should be charged to tax in the same way as income from other savings.

Chapter 12: The Taxation of Fringe Benefits

38. Fringe benefits should be charged to tax on the basis of the market value of the property, services or facilities furnished by the employer subject to exceptions in respect of working conditions and on the grounds of administrative convenience.

39. The Revenue Commissioners should keep the taxation arrangements applying to benefits-in-kind under review. They should concentrate on bringing the most important items into charge and apply *de minimis* provisions where benefits are small or disproportionate administrative problems arise provided the benefits in question are available to all employees in a firm on a non-discriminatory basis.

40. The Revenue Commissioners should publish a scale of charges to be used in assessing the benefit-in-kind arising from the provision of a car by

an employer which may be used for an employee's private use. This scale should take account of the factors mentioned in paragraph 12.26. Taxpayers should be offered the right of appeal against the application of scale benefits.

41. In the case of employees who use their own cars in the course of their business and are reimbursed on the basis of a mileage allowance, any remuneration element in the reimbursement should be charged to tax on the lines proposed in paragraph 12.27.

42. The benefit arising on loans to employees at preferential rates of interest should be charged to tax. The amount of the benefit should be calculated as the difference between the amount of interest payable at the preferential rate and that payable at either commercial rates or the rate of inflation whichever is the greater.

43. The benefit arising from the occupation of living accommodation provided for an employee, which he is required by the terms of his employment to occupy for the purposes of performing his duties, should be charged to tax to the extent that it is of value to him.

44. Benefits arising from preferential university fees charged in respect of children of full-time staff should be charged to tax.

45. Education fees refunded by an employer for courses unrelated to the employer's business should be charged to tax.

46. Free or subsidised transport facilities should be charged to tax.

47. Free car-parking facilities provided to employees particularly in urban areas should be charged to tax subject to *de minimis* provisions.

48. Share options should be charged at the date the option is exercised and taxed at the difference between the option price and the market price at the date of option.

49. The income limit of £1,500 below which benefits-in-kind provided to employees are not charged to tax should be removed.

50. Discounts provided to shareholders should be taxed on the same basis as benefits provided for employees.

51. To discourage the proliferation of fringe benefits, a benefit-in-kind tax on benefits unallocated to individual employees should be considered.

Chapter 13: The Taxation of Capital Gains

52. Capital gains should be charged to tax on realisations rather than accruals.

53. In computing the amount of any capital gain or loss, the acquisition cost should continue to be adjusted by the change in the Consumer Price Index in the period between acquisition and disposal.

54. When tax is charged at a single rate, income arising in the form of realised capital gains should be charged to tax as income.

55. Capital losses should be allowable against other income subject to the anti-avoidance provisions noted in paragraph 13.40.

56. Death should be treated as a disposal of assets for capital gains tax purposes.

57. In principle, emigration should constitute deemed realisation of assets for capital gains tax purposes.

58. The exemption limit for small gains should be abolished.

59. All Government and other securities should be chargeable assets for capital gains tax purposes.

60. No change is required in the treatment of personal chattels for tax purposes.

61. The exemption of a principal private residence for capital gains tax purposes should be withdrawn.

62. Provisions allowing for the deferral of capital gains tax liability where the proceeds on realisation are reinvested in other assets should be replaced by arrangements for payment of tax due by instalments subject to interest charges.

63. The existing provisions allowing relief and exemptions to persons aged 55 years or over who dispose of business assets should be terminated.

64. Stamp duty payable on the acquisition of a house should be allowed as a credit against any capital gains tax liability on the disposal of a previous residence.

65. Consideration should be given to giving a deduction for transactions costs involved in buying and selling houses against the sale price of a principal private residence in computing liability to capital gains tax.

66. Capital gains realised by companies should be charged to tax at the same rate as other income.

67. Capital gains realised by companies which are charged to tax should carry a tax credit when they are distributed in the same way as other income.

Chapter 15: The Unit of Personal Taxation

68. A husband and wife living together should be regarded as the basic unit for tax purposes.

69. Married persons should continue to have the right to be charged to tax as single persons.

70. The income in excess of £150 per annum of children under 16 years should be aggregated with the income of the family.

71. When children leave the family unit (at age 16 years) we recommend that tax is payable on whatever property they take with them from the unit subject to the arrangements proposed in Chapter 34.

72. Where married persons opt to be assessed as single persons, the income of children under 16 years should be divided equally between the parents for tax purposes.

Chapter 16: Personal Tax—Allowances and Reliefs

73. In the year of marriage, both spouses should be taxed as single persons. However, they should have the right to opt to be taxed jointly in the year of marriage. In such a case any repayment due should be reduced in the proportion that the period of marriage in the year bears to the full year.

74. Widowed persons with no dependent children should be charged to tax as if they were unmarried.

75. On the death of a spouse, a death grant should be payable to mitigate any hardship which arises.

76. Income tax reliefs for children should be abolished and integrated with social welfare children's allowances to be made payable in respect of all children up to the age of 16 years or up to 21 years where the child is undergoing full-time education. A supplementary payment should be made in respect of incapacitated children. These benefits should not be subject to tax.

77. The additional allowance for one-parent families should be converted into a social security benefit payable in association with child benefit.

78. Age allowance should be abolished.

79. Age exemption limits for persons aged 75 years or over should be retained. For married couples the exemption threshold might be set at about average earnings.

80. The dependent relative allowance should be abolished.

81. The blind persons' allowance should be integrated with direct payments made under the Social Welfare or Health Acts.

82. The allowance for an employed person taking care of an incapacited individual should be abolished and replaced if necessary by direct payments.

83. A head of household credit should be introduced in cases in which a dependent adult relative is resident with the claimant. The credit should be equal to the difference between the credit for single and married persons.

In cases in which the credit is claimed, the dependent should be regarded as a member of the tax unit with which he resides and his income should be aggregated with that unit for tax purposes.

84. Exemption limits of general application for income tax purposes, in excess of those which result from the granting of allowances or credits, should not remain as a permanent part of the income tax code.

85. All tax reliefs which remain in the direct tax system after our proposals have been acted upon should be given in the form of tax credits.

86. The sole purpose of tax credits should be to achieve horizontal equity between persons in different circumstances. They should not be regarded as a means of exempting a particular minimum level of income from taxation.

87. Work should be undertaken to establish appropriate equivalence scales for Ireland in order to provide an approximate guide for the legislature to determine the appropriate relative amounts of tax credits.

Chapter 17: The Income Tax Structure

88. There should not be a reduced rate of income tax.

89. The objective should be to charge income tax at a single rate.

Chapter 18: Direct Expenditure Tax

90. Income tax at the higher rates should be replaced by a direct expenditure tax operated on the "expenditure adjustment method" outlined in paragraph 18.22.

91. Deductions for saving should be given in respect of increases in listed assets or decreases in borrowings.

92. Housing should be treated as a listed asset for expenditure tax purposes.

93. It is desirable that a ceiling be imposed on the amount of housing which would qualify as a listed asset. This ceiling should be fixed and maintained at a relatively high level so as to exclude the majority of individuals liable to direct expenditure tax.

94. Certain borrowings such as consumer credits and personal borrowings for consumption purposes might be ignored on *de minimis* grounds. In these circumstances, there would have to be limitations on the amounts of such borrowings which could be invested in listed assets.

95. Expenditure on antiques should be treated as consumption.

96. Direct expenditure tax could be charged on either a current or pre-

ceding year basis of assessment. We favour the basis which causes the least difficulty for both taxpayers and the Revenue Commissioners.

97. The tax unit for direct expenditure tax should be the family as for all other taxes.

98. A system of averaging as outlined in Chapter 19 should be available.

99. Gifts and bequests of listed assets should not be treated as part of the donor's taxable expenditure.

100. Both income tax and expenditure tax paid should be treated as chargeable expenditure.

101. To the extent that credits, recommended in Chapter 16, cannot be set off against liability to income tax or social security tax, they should be set against liability to direct expenditure tax.

102. The exemption threshold for direct expenditure tax in the case of families should be at least double that provided in other cases.

103. An additional credit/threshold should be provided in respect of children for purposes of direct expenditure tax only.

104. In the event of there being different rates of direct expenditure tax, double rate bands should be provided for families. However, the number of rates should not exceed three.

Chapter 19: Averaging

105. An averaging system of general application on the moving average principle should be provided.

106. The averaging period should be at least six years.

107. The starting point for averaging should be the first full year in which a particular tax unit was in existence.

108. Averaging should be confined to fluctuations in real income (or expenditure) determined by reference to the Consumer Price Index.

Chapter 20: Indexation of Personal Taxation

109. The monetary amounts of all personal tax allowances or credits and bands of taxable income should be adjusted each year by reference to the change in the Consumer Price Index over the previous period of twelve months.

110. If it is necessary for administrative reasons to do so monetary amounts should be rounded upwards.

111. To aid public understanding of the effects of inflation, the gains or losses arising from discretionary changes in income tax rates and allowances or credits should be shown by reference to the indexed position.

Chapter 21: Social Insurance Contributions

112. Social insurance contributions should be replaced by a social security tax levied at a single rate on all income including realised capital gains and gifts and inheritances.

113. The yield from social security tax should be paid into a separate Fund, along the lines of the present Social Insurance Fund.

114. Social security tax should not be allowed as a deduction in computing income or profits for the purposes of income tax or corporation tax.

115. Social security tax paid in respect of income which arises in the first place to companies should be fully imputed to shareholders when dividends are paid out of profits which have borne the tax.

116. Social security tax imputed to exempt funds or non-resident shareholders should not be repaid.

117. The basis of assessment and arrangements for collection of social security tax should be the same as for other direct taxes.

118. In present circumstances, the rate of social security tax should be about 5 per cent. The balance of the Fund proposed in Recommendation 113 should be raised from indirect taxation.

Chapter 22: Assigned Revenues

119. Taxes should not be earmarked for specific purposes.

120. The collection of health contributions should be discontinued. The revenue foregone would be more efficiently collected from general taxation.

121. The youth employment levy should be discontinued and the revenue foregone collected from general taxation.

Chapter 23: Negative Income Tax

122. The direct tax and income maintenance systems should continue to be separate.

Chapter 26: The Determination of Business Income

123. The cost of sales adjustment should be allowed by reference to stocks plus debtors, minus creditors as shown in the opening balance sheet and calculated by reference to changes in the Consumer Price Index.

124. Taxation should be assessed on the operating profit of the entity before remunerating holders of debt and equity capital.

125. Capital allowances for taxation should be retained in place of any charge for depreciation in the accounts of a business.

126. Capital allowances computed on the original cost of the asset should be indexed in line with changes in the Consumer Price Index.

127. Balancing allowances and charges should take the full proceeds of sale into account and be computed by reference to the written down value indexed for the period from purchase to sale.

128. No capital allowances should be introduced for land.

129. To ease administration, allowances for capital wastage in respect of all classes of buildings should be allowed only when the buildings are disposed of. All these assets should be regarded as chargeable assets for capital gains tax purposes. Buildings which are custom-built for specific industrial purposes should be classified as plant and capital allowances granted accordingly.

130. The distinction in the capital allowances granted to owner-occupiers and lessors of industrial buildings should be removed.

131. Capital allowances on motor vehicles should be allowed in full to the business entity.

132. In the case of assets which qualify for capital allowances, reasonably realistic write-off periods for broad classes of assets should be prescribed by statutory regulation.

133. Losses and capital allowances carried forward or backwards should be indexed upwards or downwards as appropriate by reference to changes in the Consumer Price Index.

Chapter 27: Taxation of Company Income

134. An imputation system of company taxation should be retained.

135. The rate of imputation should be increased to 100 per cent of the underlying corporation tax.

Chapter 28: Other Aspects of Company Taxation

136. The rate of corporation tax should be the single rate of personal income tax recommended in Chapter 17.

137. In the case of companies liable to corporation tax, a minimum payment of corporation tax should be made. This payment should be equal to the amount of the tax credit on distributions by the company.

138. The amount of the tax credit on a distribution should be equivalent to tax at the standard rate of income tax on the aggregate of the net distribution and the tax credit.

139. The minimum payment of corporation tax in respect of distributions should be credited against the corporation tax liability of the company.

140. The due dates for payment of tax by companies should be the same as for self-employed individuals.

141. The acceleration in the collection of tax from companies should be achieved by advancing the dates of payment by a maximum of three months per year.

142. The recommendations in relation to the period of grace and payment of interest on overdue tax which we have recommended in the case of self-employed persons should also apply to companies.

143. The special rate of corporation tax which applies to small companies should be abolished.

144. During the transition to a single rate of income tax, close companies should be taxed on the same basis as partnerships. Accordingly, the surcharge on the undistributed income of close companies should be abolished.

Chapter 30: Aspects of the Taxation of Financial Institutions

145. The income of all banks should be charged to tax in the normal way, that is, at the single rate of tax.

146. As far as the taxation of financial institutions is concerned, there is no need to limit the use of tax-related lending. We will deal with the question of whether or not tax-related lending is an efficient means of providing an incentive to industry in a later report.

147. The withholding tax recommended in Chapter 28 should not apply to distributions under tax-related lending agreements entered into under existing arrangements.

148. No further special levies should be imposed on banks.

149. Building societies should be charged to tax on their profits at the single rate of tax.

Chapter 31: Income from Self-employment

150. All income as defined should be charged to tax for a year of assessment on the basis of the income arising in that year of assessment.

151. Business expenses should be deductible anly when they are laid out wholly, exclusively and necessarily for the purposes of a trade or profession.

152. Motor expenses which are incurred wholly, exclusively and necessarily for business purposes should be allowed in full in computing the profits of the business entity.

153. In cases in which motor vehicles are used by self-employed persons, consideration should be given to restricting business motoring costs to the scale rates set down for employees.

154. Entertainment expenses which are incurred wholly, exclusively and necessarily for business purposes should be allowed in full in computing the profits of the business entity. Any private benefit arising to individuals should be charged to them as a benefit-in-kind, to the extent that the Revenue Commissioners are satisfied that the expenses incurred are unreasonable and unacceptable.

155. Taxpayers subject to direct assessment should be required to make provisional tax payments in four instalments during the year of assessment. The provisional tax should amount to 80 per cent of the lesser of the amount assessed or ultimately found to be due, in order to avoid interest charges.

156. The balance of tax due should be payable within fourteen days of the assessment being finalised, in order to avoid interest charges. Reciprocal arrangements should apply where tax has been overpaid.

157. Interest should be paid on underpayments and overpayments of tax at a rate equivalent to the rate charged on personal overdrafts by the Associated Banks.

158. A penal rate of interest should be applied to tax which has not been paid to the Revenue Commissioners after two years from the end of the year of assessment or the finalisation of the assessment if later.

159. Interest payable on late payments of tax whether by the Revenue or the taxpayer should be treated for tax purposes in the same way as other interest.

160. The two months period of grace before interest becomes payable should be abolished.

161. If it is necessary for administrative reasons to avoid the collection of small amounts of interest, this should be done by legislation authorising the writing off of amounts below a certain figure.

162. Rates paid on business property should be allowed as a credit against income tax payable on the profits of the business.

Chapter 32: Farming Profits

163. Special restrictions on the capital allowances available to farmers should be removed.

164. The same general system of taxation should apply to all farmers as to other self-employed persons.

165. The use of existing rateable valuations to determine tax liability in any way should be discontinued as soon as possible.

166. Rates on land should be abolished. Pending their abolition, rates payable should be allowed as a credit against income tax due on a current basis.

Chapter 33: Investment Income

167. All investment income should be charged to tax on a current year basis.

168. The same arrangements should apply for payment of tax on investment income as those which apply to other income from self-employment.

169. Investment income should be charged to tax at the same rate as other income.

Chapter 34: The Taxation of Gifts and Inheritances

170. Gifts and inheritances should be subject to tax the single rate of tax levied on other income.

171. The unit of taxation for the purposes of taxation of gifts and inheritances should be the same as for other taxes, i.e. the family.

172. Children should be charged to tax on whatever capital they take out of the family unit at the time they leave the family unit, subject to the special arrangements outlined in paragraph 34.15.

173. Productive assets should not attract a favourable rate of tax. The problem of financing payment of tax where the amount of liquid assets is relatively low or where the assets are not readily realisable may be dealt with through insurance schemes and liberalising the arrangements for payment of tax by instalments.

174. The basis of valuation of agricultural land should be fair market value at existing use. Farmers should be allowed to spread tax liability on an annuity basis.

175. No general relief should be introduced for assets passing by way of gift rather than inheritance.

176. We hold divergent views on whether or not there should be an exemption threshold for purposes of tax on gifts and inheritances and if so, how much it should be. We are all agreed that the existing threshold of £150,000 for immediate relatives would be much too high in the context of our recommendations and should be substantially reduced when these are implemented. Any threshold should be index-linked.

177. We hold different views on the question of consanguinity reliefs. If these are conceded, they should be implemented by reducing any exemption thresholds in cases in which the relationship is more distant rather than by increasing it for gifts and inheritances passing to children. We are all agreed that the number of classes under the present capital acquisitions tax should be reduced.

178. The practice of accepting certain Irish Government securities at face value in payment of inheritance tax should be discontinued.

179. For the purposes of calculating the amount of tax payable on any particular gift or inheritance, the value of gifts and inheritances received in earlier years should be inflated to current money values.

180. Annual gifts up to an amount of one-thirtieth of any exemption threshold adopted for taxation of gifts and inheritances should be exempt from gift tax but should be treated as taxable expenditure in the hands of the donee.

Chapter 35: Annual Wealth Tax

181. Provided income including realised capital gains and gifts and inheritances is charged to tax at a single rate on a comprehensive basis and dissavings are charged to a direct expenditure tax, there is no case for an annual wealth tax and it should not be introduced.

Chapter 37: The Taxation of Trusts

182. Trusts should be charged to income tax at the single rate.

183. Full credit should be allowed to the beneficiary for any income tax paid at the trust level when the income is distributed.

184. When income tax is charged at a single rate, the surcharge on the undistributed income of trusts should be discontinued.

185. The transfer of property by a settlor to a trust should remain a disposal for capital gains tax purposes. However, restrictions on the allowability of losses in the circumstances should be removed.

186. The death of a person with a life interest in any property should be treated as a disposal for purposes of capital gains tax.

187. Tax should be charged on the market value of property transferred into a discretionary trust and annually thereafter. This tax would be an advance payment of capital acquisitions tax. The rate of tax should be of the order of one per cent. There should be no exemption threshold. Provided the property is transferred out of a discretionary trust within thirty years, any tax paid on the property in the trust should be allowed as a credit against the liability of the beneficiary to gift and inheritance tax. The credit should be indexed and refundable. Once a period of thirty years had elapsed the credit accumulated over that period would be lost.

GLOSSARY OF TERMS

Accessions Tax:	A tax charged at progressive rates on the cumulative total of gifts and inheritances received by an individual throughout his life.
Administrative Costs:	The costs of assessment and collection of tax borne by the public sector.
Advance Corporation Tax (ACT):	Tax paid on the occasion of a dividend etc.. ACT is set against the company's tax liability on its income.
Average Rate of Tax:	Total tax paid as a proportion of the tax base.
Capital Allowances:	Allowances normally intended to give relief for depreciation of assets in a business.
Capital Gain:	An increase in the value of a capital asset.
Cash Flow:	The flow of money payments to or from a business.
Current Cost Accounting (CCA):	A system of accounting in which adjustments are made to the historical cost accounts, in accordance with the principles laid down in SSAP16, for the effects of specific price changes on business assets.
CCA Depreciation Adjustment:	An adjustment in the calculation of current cost profit or loss to allow for the difference between the depreciation charge based on the historical cost of fixed assets and the charge based normally on their gross current replacement cost.
Classical System:	A corporation tax system under which the company is taxed at a flat rate on all its income and as a separate matter the shareholders are taxed on distributions from the company.

Close Company: A company that is effectively controlled by five or fewer shareholders.

Compliance Costs: The costs in money, time and effort of assessment and collection of tax borne by the private sector.

Consumer Price Index: A measure of changes in the prices paid by consumers for the goods they typically buy

Cost Of Sales Adjustment (COSA): An adjustment in the calculation of the current cost profit or loss to make allowance for changes in the price of stock between the date of acquisition and the date of its use in the business.

Current Budget Deficit: An excess of Government current expenditure over tax revenue.

Current Purchasing Power Accounting (CPPA): A system of accounting in which adjustments are made to the historical cost accounts for the effects of general price changes on business assets.

Depreciation: The reduction in the value of an asset through wear and tear.

Direct Taxation: Taxation which is charged on individuals or companies and is paid directly by them or through their employer to the Revenue Commissioners, e.g. income taxation, wealth taxation and social insurance contributions.

Dividend: The amount of a company's profits that the board of directors decides to distribute to shareholders.

Double Taxation: The situation in which the same tax base is taxed more than once.

Double Taxation Relief: Relief given against one country's tax charge for certain taxes paid in another country on the same income.

Earned Income: That part of a person's income which is obtained as a result of the application of his

own labour either as an employee or as a self-employed person.

Efficiency: Allocating economic resources so that optimal output is achieved.

Effective Tax Incidence: Who ultimately pays a tax as a result of adjustments to economic behaviour after the tax is legally assessed.

Equity, Tax: Standards of fairness. The tax payable should accord with ability to pay.

Equity, Shareholders': That part of a company's capital provided by the shareholders.

Excess Burden: Distortion caused by taxation so that the most efficient patterns of production and consumption are not achieved.

First in First Out (FIFO): An accounting term referring to a method of valuing stocks. Under FIFO, raw materials are assumed to be withdrawn from stocks in the order in which they were put in, the oldest items being withdrawn first.

Fiscal Drag: The effect of inflation on a progressive tax rate structure; because the proportion of tax grows as additional money income is earned, fiscal drag results in more tax being collected from personal income tax each year without the need to change tax rates explicitly.

Fixed Assets: Those business assets which are purchased for continued use in production (e.g. land, plant and machinery, etc.)

Formal Tax Incidence: The point where a tax is legally assessed. For example, the formal incidence of personal income tax is personal income.

Fringe Benefits: Rewards for employment over and above the wages and salaries paid.

CCA Gearing Adjustment: This reduces the COSA and the MWCA (see below) and the CCA depreciation adjustments in the proportion that the business is financed by borrowing as distinct from equity capital.

Historical Cost Accounting: The traditional method of accounting whereby all values whether attributable to assets and liabilities or income and expenditure are expressed in terms of the original amount expended.

Horizontal Equity: The achievement of equity between persons who have the same income or capital but differ in other respects.

Imputation System: A system under which part of the corporation tax paid by a company is treated as satisfying income tax payable by the shareholder.

Indexation: Linking the tax structure to movements in an index of prices.

Indirect Taxation: That part of total tax revenue collected by means of a levy attached to expenditure or services. Value-added tax and excise duties are the principal sources of indirect taxation.

Inflation: A process of rising prices resulting in diminishing purchasing power of a given nominal sum of money.

Last in First Out (LIFO) A method of valuing stocks. Under LIFO, raw materials are assumed to be withdrawn from stocks in the reverse order in which they were put in, the most recently bought items being withdrawn first.

Marginal Tax Rate: Rate of tax paid on the last pound of additional income or capital.

Monetary Working Capital Adjustment (MWCA): An adjustment in the calculation of current cost profit or loss to take account of price changes on the working capital (excluding stocks) of a business.

Neutral Tax System: A system which does not distort economic behaviour.

Pay-as-You-Earn (PAYE): System of collecting income tax through regular deduction by the employer from earnings as they are paid.

Poverty Trap: The position in which a person who has a low income increases his earnings only to find that the loss of benefits may nearly equal or even exceed his increased earnings. It is thus very difficult for him to drag himself out of poverty by his own efforts.

Progressive Tax Structure: A system under which the average rate of tax increases with income.

Proportional Tax Structure: A system under which the average rate of tax is the same at all levels of income.

Regressive Tax Structure: A system under which the average rate of tax falls as income rises.

Roll-Over Relief: A system which enables a business to defer payment of tax on gains from the disposal of a fixed asset where proceeds are used to purchase a replacement for that asset.

Simplicity: A tax structure characterised by comprehensibility and consistency.

SSAP16: The Statement of Standard Accounting Practice on Current Cost Accounting.

Sur-tax: An additional tax on the better-off.

Taxation: Compulsory levies imposed by Governments which divert resources from chiefly private sector activities to publicly provided goods and services.

Tax Avoidance: Arranging one's financial affairs within the law so as to minimise taxation liabilities.

Tax Base: The object to which the tax rate is to be applied, e.g. income, wealth or consumption.

Tax Capitalisation:	When a tax concession is built into the capital value of an asset.
Tax Evasion:	Failure to meet true tax liabilities through not declaring income, profit or sales or claiming allowances to which no entitlement exists.
Tax Expenditures:	Subsidies, reliefs, or concessions in the tax system which reduce tax liability and have an effect on the Government's budget similar to direct expenditures.
Tax Threshold:	The level at which tax commences to be levied.
Tax Yield:	The amount of revenue which is collected from a particular tax or the tax system as a whole.
Trust:	Money or property entrusted to an individual or group of individuals to administer in the interests of others.
Unearned Income:	Income derived from assets rather than work.
Vertical Equity:	The achievement of equity between persons who have different amounts of income or capital.
Working Capital:	The aggregate of stock plus trade debtors less trade creditors insofar as they arise from the day-to-day operating activities of the business.

Part I

General Principles

CHAPTER 1

THE IRISH TAX SYSTEM IN PERSPECTIVE

Introduction

1.1 While the work of the Commission is concerned primarily with the development of future taxation policy, we begin with an outline of the evolution of the present system. This is followed by a description of the economic environment in which it has developed, with particular reference to the past twenty years. We then examine the position of the public finances in recent years and the structure of Irish tax revenue. Finally, we place the Irish tax system in its international context.

1.2 We first set out our interpretation of the terms of reference which govern the work of the Commission.

Terms of Reference

1.3 The phrase "taxation system" is used in our terms of reference. This way of regarding a collection of administratively distinct taxes is of fundamental importance. In a modern economy, where Government expenditure is at a high level, it is impossible to raise all the revenue needed from any single tax. Each individual tax will have its own merits and defects when judged by the various criteria commonly applied to taxation. When several taxes are used, they must be considered in relation to each other and their interactions and conflicts have to be studied. Whatever their individual characteristics, it is their combined impact that should be the concern of policy makers. The complete set of taxes must therefore be assessed as a whole, even though before this can be done it is necessary to examine the parts in some detail. All payments classified as taxes have two characteristics. They are compulsory payments to central or local authorities and the benefits which they finance do not necessarily accrue to the taxpayers in proportion to their payments.

1.4 We have interpreted taxation to mean those items shown under this heading in the National Income Accounts. Existing taxes include personal income tax, social insurance, redundancy and health contributions, corporation tax, capital gains tax, capital acquisitions tax, customs and excise

duties, value-added tax, stamp duties, rates, motor vehicle duties and agricultural levies. We have also considered other taxes which could replace or supplement some of these sources of revenue.

1.5 The Commission is charged with the task of reviewing the present system of taxation with "due attention being paid to the need . . . to maintain an adequate revenue yield". This may be taken to exclude from our report any substantial discussion of the relative place of taxation and borrowing in the overall public finances of Ireland. We note that in Ireland over the past decade a relatively large proportion of current expenditure has been financed by borrowing. We note also the opinion of consecutive Ministers for Finance that borrowing for current purposes must be phased out over a few years. For this reason, we have interpreted our terms of reference to mean that we are obliged to recommend a general set of measures that would assist in closing the gap between total tax revenue and current expenditure. Any proposal, explicit or implicit, that entails a reduction of present taxation in any particular area has to be matched, at the very least, by proposals that allow for increases in others. Although the great bulk of the submissions received by us contain suggestions for reducing taxation in particular areas, we have had to ask where the revenue foregone could be recouped more fairly, more simply and more efficiently. We have concentrated on devising a proper structure of taxation in Ireland which would be capable of producing varying amounts of revenue through an adjustment of the rates and we have taken the view that, for two alternative systems producing equivalent amounts of revenue, the one which charges lower rates on a wider base is to be preferred, due account being taken of the need to keep compliance costs as low as possible.

1.6 The terms of reference require us to have regard to changes in taxation that are "desirable and practicable", that achieve an "equitable incidence of taxation" and that pay "due attention to the need to encourage development of the national economy". The demands imposed by these requirements are potentially conflicting and the relative weight accorded to them may change over time. For example, a country at a relatively low level of economic development may accord a high priority to achieving economic growth through the use of fiscal incentives. At a later stage, greater attention may be paid to the distribution of income and wealth in society and accordingly a higher priority assigned to equity. The problems which arise from attempting to satisfy these requirements simultaneously are often difficult to resolve. For this reason, it is necessary to discuss the criteria against which a tax system and individual taxes are commonly measured to test their acceptability. This is done in Chapter 3.

Development of the Irish Tax System

1.7 The Irish tax system was inherited from the United Kingdom on the

foundation of the State in 1922. It had developed in a piecemeal fashion over a number of centuries. Since independence there have been two commissions of inquiry into the Irish tax system, both under the chairmanship of the Hon. Mr. Justice Cearbhaill Ó Dálaigh.

1.8 The Committee of Inquiry into Taxation on Industry was appointed on 9 October, 1953

> "to examine the effect of taxation on industrial production with particular regard to the extent to which the incidence of income taxation constitutes a deterrent to the maintenance, modernisation or extension of productive capacity; and having due regard to the interests of the general body of taxpayers, to make recommendations as to any amendments of the existing law or practice that may appear necessary and practicable".

The Committee reported on 28 March, 1956 and recommended accelerated depreciation allowances for industrial buildings and machinery and plant. Following this report, the Finance Act, 1956 provided for the granting of initial allowances of 20 per cent of capital expenditure incurred on the provision of new machinery and plant (excluding road vehicles). An initial allowance of 10 per cent of capital expenditure on industrial buildings and hotels was also introduced. The allowances for capital expenditure for industrial purposes were greatly increased in later years.

1.9 A Commission on Income Taxation was appointed on 18 February, 1957

> "to enquire generally into the present system of taxation of profits and income, its scope and structure, including the provisions for collection and for the prevention of evasion; its effects on the national economy, and the equity of its incidence; to recommend such amendments of the law as appear desirable and practicable; and if it is considered that the taxation of profits and income should be terminated, or modified in any manner involving loss of revenue to recommend alternative means of raising equivalent revenue".

1.10 The Commission on Income Taxation made seven separate reports to the Minister for Finance, the final report being submitted on 28 March, 1962.

- Following a recommendation in the Commission's First Report, a Pay As You Earn (PAYE) system for the taxation of salaries and wages was introduced with effect from 6 October, 1960.
- The procedures for the assessment and collection of income tax and sur-tax were altered in 1963 to enable the system of "one taxpayer, one charge" to be brought into operation as recommended in the Commission's Second Report.

- **A majority of the Commission recommended the introduction of a purchase tax in the Third Report but the introduction of a wealth tax, capital gains tax and an expenditure tax was rejected.**
- The Fourth Report recommended that the taxation of farmers on the basis of actual profits be extended gradually.
- The Fifth and Sixth Reports dealt with the taxation of co-operative societies and general administrative questions respectively.
- The Seventh and Final Report dealt with a wide variety of matters ranging from personal allowances, capital allowances, business expenditure and tax evasion. Many of the recommendations were implemented in later years.

1.11 Since the foundation of the State there has been no comprehensive review of the taxation system. The last review of part of the system was completed in 1962 and the system of taxation has changed substantially since then. A turnover tax was introduced in November, 1963 and a wholesale tax was added in 1966. These taxes were replaced by a value-added tax on 1 November, 1972. Income tax was extended to certain farmers and the income tax system was restructured in 1974. Estate duties were removed in respect of deaths occurring on or after 1 April, 1975 and replaced by a capital acquisitions tax on gifts and inheritances. Gifts received on or after 28 February, 1974 were made liable to tax, while inheritances received on or after 1 April, 1975 were made liable to inheritance tax. Capital gains tax and wealth tax were introduced in 1975 but the wealth tax was abolished in 1978. Corporation tax was introduced on company profits in place of the income tax and corporation profits tax by the Corporation Tax Act, 1976. Rates on private houses were removed in 1978. A fundamental change was made in the social insurance system when pay-related contributions (up to a specified maximum) were introduced in 1979. In addition to these developments, there have been many changes in the detailed provisions of individual taxes.

1.12 Before embarking on a detailed review of the tax system, it is useful to review developments in the volume and composition of public expenditure, the structure of taxation, inflation and economic growth over the last two decades.

Economic Growth

1.13 The size and shape of the Irish economy has changed significantly during the last twenty years. Between 1960 and 1980 gross domestic product at constant factor cost increased by 197 per cent. This has been

associated with a relative increase in the importance of industry and services. These trends are shown in Table 1.

TABLE 1

Shares of Agriculture, Industry and Services Sectors in Employment and in Gross Domestic Product

EMPLOYMENT	1961	1980
	%	%
Agriculture	36.1	18.9
Industry	24.4	32.0
Services	39.5	49.1
Total	100.0	100.0

GDP AT CURRENT FACTOR PRICES*	1961	1980
	%	%
Agriculture	24.0	11.0
Industry	30.0	35.0
Services	45.0	54.0
Total	100.0	100.0

*The decline in the relative contribution of agriculture to GDP is due mainly to the increase in the contribution made by industry and the dramatic increase in services rather than to an absolute decline in the agricultural sector.

Source: Economic Review and Outlook, 1981 and Department of Finance.

Inflation

1.14 The rate of inflation has increased substantially since the early nineteen sixties. For example, in 1961 consumer prices increased by 2.7 per cent. In 1981, they jumped by 20.4 per cent. The rate of inflation over the period 1961-1981, however, has not been one of steady progression. In the sixties price increases, while still relatively low, tended to move erratically if not dramatically. In 1969, the pace of inflation quickened noticeably. Then followed the period from 1970 to 1972 during which the rate of inflation increased only very gradually. Inflation accelerated sharply between 1973 and 1975. The rate of inflation declined between 1976 and 1978 but since then has increased again to very high levels. The pattern of inflation over the period 1961 to 1981 is shown clearly in Table 2 below.

Public Finances

1.15 There is a wide variety of definitions of the public sector and the choice of definition will ultimately depend on the purpose of the analysis.

TABLE 2

Consumer Price Index—All Items Annual Percentage Changes

Year	% change	Year	% change	Year	% change
1961	2.7	1968	4.7	1975	20.9
1962	4.2	1969	7.4	1976	18.0
1963	3.5	1970	8.2	1977	13.6
1964	6.7	1971	8.9	1978	7.6
1965	5.0	1972	8.7	1979	13.2
1966	3.0	1973	11.3	1980	18.2
1967	3.1	1974	17.0	1981	20.4

Source: Department of Finance.

In this review, public expenditure includes the current and capital spending of central Government and of local authorities and is defined in terms of the conventions used in preparing the National Accounts. Current expenditure on public consumption covers such items as expenditure on the purchase of goods and services (mainly the wages and salaries of public sector employees), subventions to State-sponsored bodies, current transfer payments, e.g. social welfare pensions, subsidies and national debt interest. Capital expenditure consists mainly of direct capital investment by the State, capital grants and loan repayments.

1.16 Receipts, like expenditure, may be divided into current and capital items. The main component of current revenue is taxation, while the balance consists of gross trading and investment income, transfers from abroad and miscellaneous receipts. Borrowing accounts for the bulk of capital receipts, the remainder being made up largely of capital taxes, transfers from abroad and loan repayments to the State.

1.17 Table 3 shows the growth in public expenditures and receipts in relation to gross domestic product between 1965 and 1981.

TABLE 3

Public Expenditure and Receipts as Percentage of Gross Domestic Product

	1965	1981
	%	%
Current expenditure	28.8	49.6
Capital expenditure (including borrowing)	9.1	17.5
Total public expenditure	37.9	67.1
Current receipts	30.0	43.3
Capital receipts (including borrowing)	7.9	23.8
Borrowing for current purposes	−1.2	6.3

Source: National Income and Expenditure and Department of Finance.

Table 3 shows that total public expenditure, both current and capital, grew at a much faster rate than gross domestic product. Capital receipts (mainly borrowing) grew much faster than current receipts. By 1981, expenditure for current purposes exceeded current receipts by 6.3 per cent of gross domestic product. An increasing proportion of public borrowing has been obtained from external sources.

1.18 Table 4 shows the amount of debt service charged to taxation as a proportion of total tax revenue. It also shows the change in the proportion of interest payments on loans denominated in external currency.

TABLE 4

Exchequer Debt Interest*

Year	Total debt interest	As a proportion of total tax revenue	Interest payments on loans denominated in foreign currencies as proportion of total tax revenue
	£m	%	%
1965 66	28	13.9	3.5
1970 71	59	14.3	7.6
1975	156	16.8	21.2
1976	217	17.1	24.4
1977	279	18.8	28.0
1978	361	20.9	26.6
1979	450	22.4	22.9
1980	583	22.3	28.1
1981	795	24.0	31.4

*Central Fund Services.
Source: Department of Finance.

1.19 Table 5 shows the change in the composition of public expenditure by major category between 1965/66 and 1978 as a proportion of gross domestic product. The analysis covers both current and capital expenditure. Table 5 shows that the largest increases have been on health, education, social security and welfare and service of the public debt.

1.20 The level of taxation in relation to gross domestic product has also increased in other countries. In all OECD countries, total tax revenue has increased more rapidly than national output, rising from an average of less than 28 per cent of gross domestic product in 1965 to more than 35 per cent by 1979. The corresponding figures for Ireland are 26 per cent and 34 per cent respectively.

Budgetary Policy

1.21 When introducing a supplementary budget in October, 1970 the Minister for Finance announced that the Government would in future aim

TABLE 5

Functional Composition of Public Expenditure: Current and Capital

Category	Share of gross domestic product	
	1965/66*	1978
	%	%
1. Public Debt	4.28	11.46
2. Social Security and Welfare	6.07	9.62
3. Health	3.26	6.67
4. Education	4.17	5.91
5. Transport and Communications	3.66	4.17
6. Other General Government Services	2.95	4.08
7. Agriculture, Forestry and Fishing	4.98	3.34
8. Housing	2.83	2.87
9. Other Economic Services	0.91	2.30
10. Mining, Manufacturing and Construction	1.59	2.21
11. Defence	1.42	1.79
12. Other Community & Social Services	0.90	1.37
Total	37.02	55.79

*Public expenditure is shown as a percentage of the aggregate of three-quarters of gross domestic product for 1965 and one-quarter of gross domestic product for 1966.
Source: National Income and Expenditure: Table A.24.

at a current deficit when economic activity was depressed and at a surplus in conditions of inflation.

1.22 1972 was the first year in which the budget provided for a current deficit. In the event, the actual deficit which resulted was substantially less than had been planned. Since 1972, there has been a succession of current budget deficits. In 1975, at the height of the recession which followed the 1973 oil crisis, borrowing for current purposes amounted to 6.8 per cent of gross domestic product. By 1977, the current deficit had declined to 3.6 per cent of gross domestic product. It increased sharply again in 1978 and 1979, reaching 6.9 per cent of gross domestic product in the latter year. In 1980, it was reduced to 5.9 per cent. In 1981, despite corrective measures taken in July of that year, the current deficit rose to 7.7 per cent of gross domestic product.

1.23 Government policy in relation to current deficits was outlined by the Minister for Finance in his 1982 budget statement when he said that

> "The Government are, nevertheless, firmly committed to bringing the current budget deficit under control and gradually eliminating it . . ."[1]

[1]Dáil Debates, 25 March, 1982, Vol. 333, Col. 588.

Structure of Tax Revenue in Ireland

1.24 Table 6 shows the changes in the composition of total tax revenue in Ireland between 1965 and 1979, together with estimates for 1981, and in the proportion of gross domestic product absorbed by these taxes.

TABLE 6

Structure of Taxation in Ireland

Category	Share of Total Tax Revenue			Share of Gross Domestic Product		
	1965	1979	1981	1965	1979	1981
	%	%	%	%	%	%
Personal Income Taxes	16.7	30.1	31.4	4.3	10.2	12.0
Social Security contributions						
Employers	3.3	9.1	14.1	0.9	3.1	5.4
Employees	3.2	5.2		0.8	1.8	
Corporation Income Taxes	9.0	5.8	5.0	2.4	1.9	1.9
Taxes on Goods and Services	52.7	43.7	44.8	13.7	14.8	17.2
Taxes on Property	15.1	6.1	4.7	3.9	2.0	1.8
Total	100.0	100.0	100.0	26.0	33.8	38.3

Source: Revenue Statistics of OECD Member Countries (1981 Edition) and Department of Finance.

1.25 It can be seen that personal income tax has increased in importance. This is due to rising real incomes and to the decline in the real value of personal tax allowances. The fall in the share of corporate taxation reflects the fact that much of the expansion in the industrial base resulted from new manufacturing industry which qualified for a wide range of tax reliefs. The drop in the share of property taxes is due largely to the transfer during the period from local to general taxation of that part of the cost of the health services and local authority housing charges which used to be borne on the rates and by the removal of rates from domestic property in 1978.

1.26 Valid international comparisons are notoriously difficult to make and taxation is no exception. A measure commonly used to compare levels of taxation in different countries is the proportion of gross domestic product absorbed by total taxation and by individual taxes. Comparisons on this basis are published by the Organisation for Economic Co-operation and Development (OECD) in its "Revenue Statistics of OECD Member Countries". The figures are, of necessity, somewhat out of date, the latest year for which detailed figures are now available being 1979. Table 7 shows the proportion of gross domestic product absorbed by total taxation and by individual taxes in OECD countries. Because of the relatively low level of gross domestic product per head in Ireland, care must be taken in drawing

conclusions about the overall level of taxation in Ireland compared with other OECD countries on the basis of the available data.

TABLE 7

International Tax Comparisons OECD Countries 1979 as a Share of Gross Domestic Product

	GDP per head	Total Taxes	Personal Income Taxes	Social Security Contributions	Corporate Income Taxes	Taxes on Goods and Services	Taxes on Property
	US $	%	%	%	%	%	%
Industrialised Europe	9,876	40.7	13.1	10.5	2.8	11.7	1.7
Non-Europe OECD	8,900	28.8	11.7	3.7	3.5	7.2	2.7
Less-industrialised Europe	3,257	24.4	4.2	7.1	0.8	8.5	1.2
Ireland	4,393	33.8	10.2	4.9	2.0	14.8	2.1
OECD average	8,274	35.2	11.7	8.3	2.6	10.3	1.9
Ireland's ranking amongst 23 countries	20th	12th	15th	17th	13th	3rd	11th

Source: Revenue Statistics of OECD Member Countries (1981 Ed.).

22 OECD countries excluding Ireland have been grouped as follows:

Industrialised Europe comprises Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, Netherlands, Norway, Sweden, Switzerland and the United Kingdom.

Non-Europe OECD comprises Australia, Canada, Japan, New Zealand and the United States.

Less-industrialised Europe comprises Greece, Portugal, Spain and Turkey.

1.27 Bearing this qualification in mind, the following points stand out:

(i) The proportion of gross domestic product being taken in tax in Ireland in 1979 was 33.8 per cent compared with an OECD average of 35.2 per cent. By this measure, Ireland had the lowest taxation in the EEC (average of 39.9 per cent of gross domestic product).

(ii) Indirect taxation in Ireland accounts for an unusually high share of gross domestic product, while the shares of corporate income taxes and social security contributions are relatively low.

(iii) The share of personal income tax is a little below average, while property taxes are roughly in line with the OECD average.

1.28 Table 8 shows the share of total tax revenue in OECD countries accounted for by the various heads of revenue. This broadly confirms the results derived from Table 7.

TABLE 8

International Tax Comparisons OECD Countries 1979 as a Share of Total Tax Revenue

	Personal Income Taxes	Social Security Contributions	Corporate Income Taxes	Taxes on Goods and Services	Taxes on Property
	%	%	%	%	%
Industrialised Europe	32.0	26.5	6.4	28.8	4.3
Non-Europe OECD	38.8	13.1	12.1	24.2	9.2
Less-industrialised Europe	18.9	28.5	3.3	34.1	5.1
Ireland	30.1	14.3	5.8	43.7	6.1
Ireland (1981 provisional)	31.4	14.1	5.0	44.8	4.7
OECD average	32.6	23.4	7.4	29.4	5.6
Ireland's ranking amongst 23 countries	12th	16th	13th	2nd	9th

Source: Revenue Statistics of OECD Member Countries (1981 Ed.) and Department of Finance.

Summary

1.29 The main developments in the field of Irish public finance in recent years may be summarised as follows:

(i) There has been a rapid increase in public expenditure so that by 1981, it amounted to over 67 per cent of gross domestic product compared with less than 38 per cent in 1965.

(ii) Public social expenditure on health, education and social welfare services has increased from 13.9 per cent of gross domestic product in 1965 to 22.2 per cent in 1978, while the share allocated to the infrastructural and productive areas of agriculture, forestry, fishing and housing has declined from 8 per cent of gross domestic product to 6.2 per cent over the same period. At the same time, the share taken up by debt service payments increased from 4.4 per cent to 11.5 per cent.

(iii) The share of gross domestic product raised in personal income taxes rose from 4.3 per cent in 1965 to 12.0 per cent in 1980.

(iv) Since the early 1970's, public borrowing has exceeded the level of public investment; thus public consumption has been financed in part by Government borrowing. The taxation needed to pay for this increased current spending has been postponed.

Public Finance Options

1.30 It is clear to us that continuing high current budget deficits are unsustainable and must be reduced. Further resort to borrowing for current purposes is not a realistic option for four reasons[2]. Firstly, a consistently high borrowing requirement, such as has been experienced in Ireland since 1974, reduces the scope for counter-cyclical action during periods of low economic activity. Secondly, the monetary financing of the borrowing requirement can have adverse effects on price inflation and the current balance of payments deficit. Thirdly, public borrowing used to boost or maintain consumption merely defers taxation into the future. Fourthly, too high a proportion of the borrowing requirement has been raised abroad.

1.31 The only course is, therefore, to reduce Government borrowing. This is likely to require reductions in Government expenditure and/or increases in taxation. The problems in these areas have been outlined by the National Economic and Social Council:

> "The magnitude of the change required can be gauged from the likely size of the current budget deficit over the next few years on the basis of assumptions of no change in the volume of public expenditure, and indexation of specific rates of indirect taxation and of income tax allowances. If the adjustment were to be concentrated on current expenditure alone, it would require an average annual decrease of about 5.9 per cent in expenditure (compared to what it otherwise would be) over the three year period (1981-1983)"[3].

1.32 We have not considered whether reductions in current expenditure of the magnitude referred to in the NESC Report are either feasible or desirable in terms of their impact on the community. Neither have we considered the extent to which taxation might be raised to reduce the current budget deficit. Nor have we considered the timing of any reduction in the current budget deficit. All these matters are outside our terms of reference. Instead, we have concentrated on the overall structure of the tax system. Given the system, it is for Government to determine the tax rates which will yield the revenue that is deemed necessary at any particular time.

---

[2] *Economic and Social Policy 1980-83: Aims and Recommendations*, NESC Report No. 53, Chapter 6.

[3] Report No. 53, Paragraph 6.50.

Conclusion

1.33 From this brief review of developments, a number of points become obvious. Firstly, the structure of Irish taxation has changed considerably during the last twenty years. Secondly, the level of inflation is much higher than would have been conceivable twenty years ago. Thirdly, the level of public current expenditure as a proportion of national income has increased much faster than tax revenue as a proportion of national income. The resultant current budget deficit cannot be sustained indefinitely. Any reduction in this deficit is likely, in the absence of a sharp increase in economic growth, to require some combination of expenditure cuts and tax increases.

1.34 From the many submissions made to us, it is also clear that, despite the very wide gap between public current expenditure and tax revenue, there has been an increase in the level of public dissatisfaction with the tax system. This dissatisfaction has been expressed in the form of concern about the level of taxation and its distribution among the various sectors in Irish society. For this reason, and also in view of the many developments alluded to earlier, we believe a comprehensive review of the tax system is timely.

CHAPTER 2

CRITICISMS OF THE TAXATION SYSTEM

Introduction

2.1 We received a substantial number of submissions which contained criticisms about the existing taxation system and suggested changes. In this chapter we summarise the main criticisms. The list is not exhaustive, though the main themes are covered. We have borne these criticisms in mind in drafting our report and our assessment of the extent to which they are justified is set out in the body of the report.

2.2 The criticisms received may be grouped under three broad headings. The first relates to the equity of the system. The second reflects concern about the complexity of Irish taxation. The third raises the question of the disincentive effects of taxation, particularly income tax.

Equity

2.3 The greatest volume of criticism alleged that the tax system is unfair. Those subject to PAYE consider that they are paying an excessive share of total tax revenue. They feel that the financial institutions, the farming community and the self-employed generally are contributing too little. The self-employed consider that the benefits enjoyed by those in secure employment should be taken into account and cite instances in which the self-employed are treated less favourably than employees. The non-manufacturing sectors of the business community (including farmers) believe that they should be given the same reliefs as the manufacturing sector. It can be said that every incentive and "special case" which has been introduced has given rise to some complaint, on the grounds of equity, from those excluded from its benefits.

2.4 Some submissions suggested that, because of the alleged inequities of income tax, there should be a switch from direct to indirect taxation. Others were strongly in favour of continued reliance on income tax provided that the income tax code and/or the tax system was reformed to make it more equitable. A few advocated greater reliance on direct taxation.

2.5 There was almost universal agreement that indexation of income tax allowances and tax bands should be introduced to offset the distortions

resulting from the interaction of rapid inflation and a progressive taxation system with allowances and tax bands that are fixed in money terms. The acceptance of some form of current cost accounting as the basis for computing profits for tax purposes was widely supported by the business community.

2.6 We received many representations to the effect that self-employed persons should be assessed for income tax on the basis of current earnings rather than on the preceding year basis as at present. This method of assessment is viewed as bestowing a positive benefit on self-employed persons, especially in periods of rapid inflation. The fact that self-employed persons may claim relief in respect of a wider category of expenses than employees was also criticised. There is also a widespread belief that the opportunities for avoidance and evasion of direct taxation are not equally distributed among taxpayers and that there should be stricter enforcement of the law and elimination of loopholes.

2.7 It was argued in some submissions that the exemption of a large number of farmers from income tax was inequitable. The agricultural community, in turn, regarded certain aspects of the tax system as it applied to farming to be unfair and unsuitable. The rating system was seen to discriminate against farmers.

2.8 Some submissions drew attention to the fact that income tax allowances and reliefs are given in the form of deductions from income and this means that the value of these deductions, in terms of tax saved, is determined by the marginal rate of tax at which the claimant is liable. We received representations which suggested that tax allowances should be replaced by a scheme of tax credits, under which reliefs are expressed in terms of tax saved rather than as deductions from income. Some submissions suggested that most, if not all, of the present income tax allowances and reliefs should be withdrawn. A number of submissions argued that the combined value of tax and social welfare allowances for dependent children had been eroded in recent years and that their real value should be restored.

2.9 There were widely divergent views about capital taxation. Submissions which took the view that equity in taxation was paramount argued that capital taxation was inadequate. Other submissions argued that the revenue to be raised from capital taxation was not significant and that account should be taken of the economic effects which were stated to be adverse, particularly in the case of wealth tax.

Simplicity

2.10 There was widespread criticism of what is seen as the unnecessary complexity of taxation, which gives rise to frustration among taxpayers,

suspicion that they are not obtaining fair treatment, administrative delays and a heavy burden in terms of money, effort and time, particularly on small businesses. The introduction of simpler tax forms and procedures and a reduction in the number of refinements in the system were seen as desirable simplifications.

Incentives

2.11 High marginal tax rates were viewed as a disincentive to work. It was alleged that workers refuse to do overtime because of high taxation. Furthermore, it was argued that the interaction of the tax and social welfare systems made it increasingly attractive for workers to claim unemployment or disability benefit for short periods. The integration of the two systems was recommended.

2.12 The treatment of manufacturing industry for tax purposes was widely regarded as being favourable. Representations were received from other sectors for similar treatment. Other submissions favoured a reduction in the concessions to industry.

2.13 There were numerous proposals for the introduction of additional incentives to encourage savings and investment. Some submissions argued for the rationalisation of existing concessions to remove anomalies which are seen to exist.

2.14 We also received a wide variety of suggestions for the introduction of new tax reliefs to encourage particular activities. Little or no attempt was made to suggest how the revenue foregone might be raised.

Conclusion

2.15 The list of criticisms which we have outlined in this chapter is by no means exhaustive. However, it serves to show that there is widespread dissatisfaction with the present tax system. Unfortunately, there is no consensus about the measures that are necessary to reform it.

CHAPTER 3

CRITERIA FOR TAX SYSTEMS

Introduction

3.1 In this chapter we discuss the criteria of equity, efficiency and simplicity against which a tax system should be judged. We identify some of the main international and other constraints which influence the design of the tax system. We also examine the question of tax expenditures, namely, reliefs or exemptions, which are not part of the essential structure of the tax in question but are akin to direct Government expenditure in terms of revenue foregone.

Equity

3.2 Equity is an essential quality of the tax system. Taxation in accordance with ability to pay provides an ideal to which almost everyone can subscribe. However, this ideal is difficult to achieve in practice. It is customary to distinguish the two dimensions of horizontal and vertical equity: persons in the same situation should be treated equally, and those more favourably placed should be required to pay more.

3.3 The notion underlying both aspects of equity implies that tax is a sacrifice levied upon some kind of personal economic well-being. For practical purposes, both the "sacrifice" by way of tax and the "well-being" upon which the tax is levied have to be measured in money terms. Many of the most difficult questions in tax policy stem from the conventions that must be accepted when making the transition from the notion of "economic well-being" to the choice and exact definition of what is to be the measure of "well-being" — the tax base.

3.4 An alternative principle which might be considered as the basis for allocating taxation is that of "benefit", which relates taxes to the benefits individuals are estimated to receive from goods and services provided by the State. Except in a small number of cases where revenue is raised in the form of fees or prices for the direct use of publicly-provided services by particular individuals, this principle is very difficult to apply. In any event, it ignores the notion of equity which is generally accepted by taxpayers.

We believe that taxation should primarily be levied in accordance with ability to pay.

3.5 In discussing equity, the term "burden of taxation" is frequently used. We believe that the implication in this phrase that all taxes constitute a diminution of welfare for which the citizen receives nothing in return is incorrect. Many of the services financed from taxation are essential to the efficient functioning of the private sector, and many are carried on by the public sector because this is the most efficient method — and for some services the only way — of doing so. In addition, much present taxation is part of a process in which money is taken from people at one stage of their lives only to be returned to them at another time of greater need. To describe taxation as a burden in these circumstances is, in our view, misleading.

3.6 The notion that taxes as a whole are a burden probably arises because taxes are compulsory and payment is divorced from the receipt of the benefits arising from public expenditure, which most citizens take for granted. For example, the benefits of law and order and defence services are impossible to attribute to taxpayers on an individual basis. Moreover, many taxpayers claim they know of some Government expenditure which they regard as useless and wasteful. Nevertheless, we reject the notion which regards taxation as a burden. On the contrary, we believe that taxation is a necessary means of providing public services to the community.

Efficiency

3.7 The tax system is also seen as an instrument for encouraging (or at least not discouraging) efficiency in the use of resources, through its effect on productive activity, risk-taking, enterprise, work effort and saving. The effects of the tax system on efficiency will depend to a large extent on the total level of taxation. If a high level of public expenditure has to be financed, some tax rates will be high, with inevitable disincentive effects.

3.8 In so far as individuals when left to their own devices will spend their income wisely and business will choose the most efficient means of production, the minimisation of waste requires that a tax system should not influence individual or business choices. This requirement of neutrality in a tax system means that it should not interfere with the relative rewards of the different types of work between which an individual must choose, the relative attractions of work and leisure, the relative returns from different types of investment or relative factor and goods' prices. The concept of neutrality assumes that resources are being used in the most efficient manner before the imposition of the tax. This cannot be taken for granted because producers and consumers may fail to take account of "externalities", that is, the effects of their activities on third parties. Therefore, efficiency may be improved by a departure from neutrality. For this reason, tax concessions

may aim at increasing the output of goods and services which it is desired to encourage. Alternatively, taxes may be imposed on activities which it is desired to discourage.

3.9 It is now widely accepted that the level and pattern of taxation should be determined in such a way as to help regulate the level, direction and rate of change of economic activity, with particular reference to the growth of production, real incomes and employment, the stabilisation of costs and prices and the control of the balance of payments. A good tax structure must be flexible so that total receipts from taxation can be adjusted fairly rapidly and frequently. At the same time, there is a clear need for a certain stability in taxation in order that taxpayers can make reasonably long-term plans. Uncertainty breeds lack of confidence and is a serious impediment to production and prosperity. There is an obvious clash between these requirements. The solution would seem to lie in avoiding frequent and fundamental changes in the whole tax structure which, in turn, depends on finding a structure of taxation which is broadly acceptable to different political opinion, but which is flexible enough in its rate structure and detailed operation to enable different emphases to be put on different tax objectives from time to time.

Simplicity

3.10 Another desirable quality of a tax system is that it be coherent, simple and straightforward. Simplicity in a tax system is achieved if the administrative costs of tax collection are small and if the compliance costs for the taxpayer both in terms of money and mental effort are also small. These ideas are related to the canon of certainty postulated by Adam Smith over two hundred years ago. For example, uncertainty about what is due and when it is due may entail costs of consultation with tax advisers. Secondly, it is vital to democracy that the taxing authorities are accountable to the electorate. This can only be so where ordinary people can understand clearly what is taxed, when it is taxed and how much it is taxed. The principle on which the tax base is chosen should itself be simple and logical.

3.11 Three further aspects of simplicity should be noted. When a complex operation is needed before liability can be ascertained, it is desirable that the taxpayer, for purposes unconnected with tax, already needs to perform such operations. For example, an income tax is not simple if it obliges many taxpayers, who would otherwise not wish to do so, to keep many records and learn sophisticated accounting systems. Secondly, the smaller the number of taxpayers for any given amount of revenue with whom the administration has to deal, the simpler is the system. While in many instances there is a conflict between the demands of equity and simplicity, it should not be forgotten that if a tax is unnecessarily complicated, it is

likely that the disadvantaged in society will be unaware of their rights and this is likely, in practice, to distort the equity of the system.

3.12 A tax system must be acceptable to the public and to be acceptable it must be understandable. Furthermore, if a tax system is based on simple, clear-cut principles any concessions to special interests will be highlighted.

3.13 The total social costs of collection must include private compliance costs and official administrative costs. In some cases (for example, PAYE) the cheapest method of collecting a tax may well be to make use of private individuals as agents. It may even be argued that the imposition of some collection costs on the private sector may lead to a desirable insistence on simplicity in the interest of reducing these costs. On the other hand, there are a number of reasons for tipping the balance away from private compliance costs to official administrative costs, where it is possible to choose administrative arrangements which have this effect. Firstly, administrative costs are met from taxation, which can itself be determined with reference to fairness of tax burden, whereas compliance costs fall on the private taxpayer and can be very regressive. Secondly, compliance costs are likely to be much resented by taxpayers, particularly where much time and trouble must be spent by low income taxpayers, only to show a very small or nil liability to tax. In addition, it is much easier to ascertain the level of administrative costs, which are more open to public scrutiny, than private compliance costs.

Conclusion

3.14 There may be considerable conflict between the demands imposed by these criteria. At one extreme, a simple tax such as a poll tax, that is, a tax levied per head of population, could be highly inequitable. Complexity is invariably increased when allowances are introduced on equity grounds. There must also be some compromise between the expense and intrusiveness of a rigorous administration and the losses of revenue suffered when administration is comparatively trusting.

3.15 The Irish tax system has grown in a piecemeal fashion. In this report we conclude that it is inequitable and unnecessarily complicated in certain respects. There is a large number of special concessions designed to encourage particular activities and to give special relief to particular sectors. The introduction of each new concession dilutes the effectiveness of each existing incentive without reducing its cost and eventually the equity of the whole system and its efficiency become eroded. We have concluded that there is some scope for the retention of certain incentives in the tax code. However, steps must first be taken to increase the equity of the system.

International Constraints

3.16 In addition to these criteria, we have had to bear in mind a number of constraints imposed by specific international or other obligations. In Ireland's case these arise under three broad headings:

(i) There are general obligations undertaken with membership of international organisations of broad scope such as the General Agreement on Tariffs and Trade (GATT).

(ii) There are the more specific obligations and proposals for tax harmonisation of the European Economic Community.

(iii) There are a number of double taxation agreements with other countries containing specific rules for the treatment in one country of taxes levied in the other.

3.17 Constraints can also arise from the need to have regard to the fiscal regimes which apply in other countries. For example, Irish taxes must have regard to the relative competitive position of businesses which have to compete on international markets. Regard must also be had to the mobility of scarce factors of production such as capital and skilled labour, which may leave Ireland if the fiscal climate becomes unattractive compared to that of other countries.

Tax Expenditures

3.18 In our consideration of the tax system we have also looked at the general issue of tax expenditures. A tax expenditure is an exemption or relief which is not part of the essential structure of the tax in question but has been introduced into the tax code for some extraneous reason, e.g. in order to ease the burden for a particular class of taxpayer or to provide an incentive to apply income in a particular way or perhaps even to simplify administration. The choice of the term "tax expenditure" indicates that because these reliefs are not inherent in the structure of the tax they are equivalent in terms of revenue foregone to direct Government expenditure and should in general be judged by the same criteria and subjected to the same review process.

3.19 The effect of tax expenditures is to erode the tax base so that higher rates of tax than would otherwise be necessary must be imposed on the remainder of the base in order to raise a given revenue. Erosion of the tax base puts a premium on earning and disposing of incomes in forms that receive preferential treatment, thus often distorting the allocation of resources and departing from the principle that taxpayers with equal incomes and "similar circumstances" should pay the same tax. These departures from strict equity principles inevitably create pressures for the enactment of additional concessions. These pressures are difficult to resist if there is an absence of simple, clear-cut principles to underpin the tax system.

3.20 The erosion of the tax base has taken place the more easily because the cost of tax reliefs tends to be overlooked since it is not reviewed annually

as with direct public expenditure. We have noted that, despite the large amount of time devoted each year by the Oireachtas to discussion of taxation during debates on the Budget and Finance Bill, there is no regular and systematic public review of individual tax reliefs. The matter continues to be regarded as solely the concern of the Minister for Finance for consideration in a budgetary context. Once tax reliefs are introduced, it becomes exceedingly difficult to withdraw them, even when the original reason for their introduction no longer applies. This is due primarily to the strong resistance which is put up by the main beneficiaries of those reliefs whenever proposals for the withdrawal of reliefs are mooted. The cost of many concessions is unknown to the general public since the information is not published on a regular basis.

3.21 In the light of these considerations, we believe that it is desirable, in principle, to switch from the use of tax expenditures to direct Government expenditure where this is feasible. We also recommend that a tax expenditure budget should be introduced in Ireland. This would be published regularly and would list all items of tax expenditure and their associated costs in terms of revenue foregone. The object of this exercise would be to promote public awareness of tax expenditures and their cost and to ensure that they are reviewed as regularly and as carefully as direct public expenditure to which they are equivalent.

Recommendation

3.22 We make the following recommendation:

1. A tax expenditure budget listing the cost in terms of revenue foregone of all items of tax expenditure should be published regularly.

CHAPTER 4

APPRAISAL OF VARIOUS TAXES

Introduction

4.1 The main kinds of taxation must now be evaluated by reference to the criteria outlined in Chapter 3. These taxes will all be examined in more detail later. However, a brief summary will assist in a discussion of alternative types of tax systems. This is not an evaluation of the taxes at present levied in Ireland but an assessment of various taxes which could form part of the tax system. At this stage of the analysis we assume that prices are stable. We discuss in Chapter 7 the distortions that can occur under a tax system that is not designed to cope with inflation.

Personal Income Tax (including employees' social insurance contributions)

4.2 If income is accepted as the primary criterion in comparisons between the ability to pay of individuals, it follows that, provided the problems of definition and administration can be dealt with in a satisfactory way, a personal income tax can be more equitable than other taxes. A large number of provisions for horizontal equity can be accommodated and, in theory, any desired degree of progressivity can be achieved. Income tax can also be relatively simple in theory. However, complexity is introduced when a multiplicity of allowances is provided for equity reasons. This is aggravated when, with a highly progressive scale, measures have to be taken to prevent the avoidance of tax at the higher rates by the use of companies or other means. If it is to raise large amounts of revenue, income tax must fall on almost every person with income, most of whom have little taste for form-filling and many of whom, but for the obligations under income tax law, would not keep financial records. The definition of income for tax purposes causes great difficulty. Further, there must be a perpetual compromise between vigorous anti-evasion measures and the losses of revenue suffered when the administration depends largely on voluntary compliance.

4.3 As regards the effect on the allocation of resources, personal income tax can be made the vehicle for deliberate departures from neutrality to encourage particular activities. Considered against the criterion of neutral-

ity, income tax is not neutral between work and leisure. However, it shares this defect with many other taxes.

Grants

4.4 Cash grants by the State provide an alternative to concessional deductions in the personal income tax as a means of achieving equity. Whether taxed or not, they will, when given at a flat rate, increase somewhat the net progressivity of the tax system. Because they constitute an even smaller proportion of the incomes of recipients with higher incomes they tend to equalise the distribution of income. When free of a means test, they are simple to administer since eligibility is determined by tests such as age, parenthood, sickness or unemployment. Moreover, in general, they are neutral. For example, unless the benefits are very large, it is unlikely that children's allowances would encourage larger families or that well-administered sickness or unemployment benefits significantly increase the incidence of illness or unemployment.

Capital Gains Taxes

4.5 Capital gains are a form of income and equity and efficiency require that they be taxed as such. On equity grounds, a capital gains tax has great merit as a complement to personal income tax and is desirable on the grounds of resource efficiency. When capital gains are untaxed but other income is, investments in the kinds of asset on which returns come (or can be arranged to come) in the form of capital appreciation will be relatively more attractive. A misallocation of resources is likely in these circumstances which the tax serves to correct. As against this, taxes on capital gains tend to be relatively complicated to administer.

Gift and Inheritance Taxes

4.6 Gift and inheritance taxes may be regarded as taxes on income defined in a comprehensive way or as taxes on the transfer of capital. If other income is taxed, their main justification is on equity grounds, since receipts from gifts and inheritances confer the same command over economic resources as other income. They may also be used to prevent an unequal distribution of wealth being passed on tax-free to the next generation. In this sense, they increase equality of opportunity and potential competition. However, their provisions need to be elaborate. Since they are not levied annually and it may be possible to confine them to larger transfers of wealth, they are simple in the sense of not affecting the majority of the population. They may also tend to discourage accumulation of wealth for the benefit of heirs and if applied to the transfer of income-producing entities may result in the fragmentation of these productive assets with undesirable economic consequences in certain circumstances.

Payroll Taxes

4.7 Payroll taxes are most commonly levied on employers in the form of pay-related social insurance contributions. Their main defect from the point of view of the allocation of resources is that they increase the cost of labour relative to capital and other factors of production and thereby tend to depress employment. Payroll taxes reduce competitiveness since they enter into the cost of home-produced goods but not of imports. To that extent they are inferior to a value-added tax. As far as equity is concerned, if it is assumed that the taxes are shifted forward into prices, they rank about equally with broadly-based indirect taxes on expenditure but with a bias against labour-intensive as compared with capital intensive products.

Corporation Tax

4.8 Corporation tax is a difficult tax to appraise from an equity standpoint in that companies may be regarded either as being entities separate from their shareholders or as being, in essence, a group of shareholders banded together with the objective of achieving a common purpose with the advantage of limited liability. However, equity is essentially a matter of comparative justice between individuals. A tax on companies may or may not be fair to its owners, employees, customers or suppliers but it cannot be said to be either fair or unfair to the company as such. When the tax is held to fall on the income rights of the owners, its fairness will depend on whether the sum paid is equal to what would be paid were the income in question simply added to the other income of the individual proprietors. Neither in Ireland nor elsewhere is this, in fact, generally the case.

4.9 Corporation tax can be a simple tax. The problem of ascertaining the income of the company is, in principle, no different from that of personal income, but the necessary accounting procedures are likely to be required already for the company's own purposes and hence more readily available. However, when incentive provisions are introduced into the system, it becomes more complex and the compliance costs increase.

Direct Expenditure Tax

4.10 A direct expenditure tax is a direct tax on personal consumption expenditure. It is computed separately for each individual by reference to what he spends during the tax year. It should not be confused with indirect taxes on expenditure such as value-added tax or excise duties. While a direct expenditure tax has been widely debated, it has been introduced in relatively few countries.

4.11 Broadly speaking, there are two types of expenditure tax, the comprehensive type and the partial type. The former applies to all taxpayers and is usually seen as a substitute for an individual income tax. The latter

applies only to a segment of the taxpayers, normally those in the higher income brackets and tends to be seen in the role of a supplement to an income tax. For expenditure tax purposes, expenditure is defined as total receipts less increase in net worth and the tax return includes a statement of assets acquired and disposed of during the year together with a statement of income from all sources.

4.12 Like income tax, the expenditure tax can be progressive. It is less likely than income tax to act as a disincentive to additional work and the undertaking of high risk business ventures, insofar as it taxes the taxpayer on what he takes out of the pool of resources of the community, namely, consumption, rather than on what he puts into the pool, namely, income. Unlike income tax, expenditure tax is neutral as between present and future consumption. It is, however, a new form of taxation and there would be practical difficulties if it were desired to introduce a universal expenditure tax in place of income tax.

Indirect Taxes

4.13 A distinction must be made between "narrowly-based" taxes falling only on a few consumption goods and services (even if they absorb quite a significant proportion of consumer expenditure) and "broadly-based" taxes on very large ranges of goods and services. In Ireland, excise duties are an obvious example of the former category and value-added tax belongs to the latter.

4.14 Narrowly-based indirect taxes on goods and services rank very badly in terms of equity. They discriminate between persons with the same incomes but different tastes. They rank well in terms of efficiency only when the amount of taxation imposed by them is related to the social costs imposed by the activities charged. It may, perhaps, be desirable to levy a heavier burden on the motorist, smoker and drinker than on others, but it must be remembered that the real sacrifice may be borne by the families of those whose activities it is intended to discourage. Nor can such taxes be made in any way effectively progressive in terms either of income or expenditure. They are, however, taxes of extreme simplicity. Very few enterprises have the legal responsibility for payment and these will already have the machinery for calculating the liability as part of their normal activities. In terms of the allocation of resources, it is obvious that these are not neutral taxes.

4.15 A broadly-based tax on goods and services levied at a single rate is essentially a proportionate expenditure tax and may actually be regressive in relation to income if expenditure tends to fall as a proportion of income

as income increases. These effects may be mitigated if it is possible to levy higher rates of tax on goods and services that account for a higher than average proportion of the expenditure of higher income taxpayers. Broadly-based expenditure taxes are potentially much more simple than income taxes when both are compared as major revenue raisers, but this advantage is greatly reduced if the rate is not uniform. Such taxes give rise to problems of definition and the larger the number of different rates the more acute they will be. A broadly-based tax at a uniform percentage rate is inherently neutral within its range but is not neutral between savings and consumption.

Stamp Duties

4.16 Stamp duties are a form of indirect taxation which are levied on the transfer of property and securities. They can be made progressive in relation to the amount of property transferred. As far as they affect the allocation of resources, they score less well since they may inhibit the transfer of property and securities.

Wealth Tax

4.17 A wealth tax is a recurrent tax levied on total net worth, defined as the difference between the total assets and liabilities of the taxpayer. Wealth taxes may be justified on equity grounds, if it is considered that income by itself is an insufficient indicator of ability to pay or that wealth yields advantages to its owner over and above the income derived from it. These advantages may be in the form of security, independence and opportunity. Wealth taxes may also be justified on grounds of economic efficiency if they encourage people to use wealth more productively, thereby improving the allocation of resources. Other efficiency considerations are the extent to which they reduce barriers to entry to various fields of economic activity (i.e. increased competition) and the extent to which they may discourage investment. However, they are less simple than gift and inheritance taxes in that they are levied much more frequently.

Property Taxes

4.18 Property taxes can best be described as partial wealth taxes levied on a recurrent basis on the value of specified assets. Local rates are a form of property tax. If such a tax is levied on realistic market values, it is less inequitable than is commonly assumed. However, it may be regressive over certain income ranges and it responds slowly to fluctuations in the income out of which it is paid. The liability is clear and the tax is simple to collect. The main problems under this heading arise in keeping the valuation base up to date, but this is a difficulty for the administrator of the tax rather than the taxpayers. The tax may not be neutral if it applies only to real

property, which forms a greater proportion of the assets of some businesses than of others.

Conclusion

4.19 The short assessments just given of the principal taxes which may form the elements of any tax system assist in classifying the options. It is clear that different tax systems made up of these elements will serve the different aims of equity, simplicity and efficiency to varying degrees.

4.20 In general, it can be said that there are conflicts between the three different criteria. In our examination of the tax system, we have borne these criteria in mind. Where existing provisions are complex, inequitable and inefficient our task has been easy. Where there is a conflict inevitably we have had to make judgements.

4.21 The potential conflict between simplicity and equity is particularly great. The taxes most clearly adaptable to the requirements of equity are those which are capable of being varied so as to take account of the many differences in individual situations which are considered relevant to equity. These are the most complex of taxes: income tax, capital gains tax, gift and inheritance taxes and wealth tax.

4.22 The clash between simplicity and efficiency is not so great. Certainly, if efficiency can be regarded as mainly requiring neutrality, reliance on a very simple, broadly-based tax at uniform rates on all consumption expenditure would produce a tax system that was relatively simple and efficient. Though efficiency may require additional taxes for special purposes, these could be few in number, if policy instruments other than taxation are also used. However, if efficiency requires substantial departures from neutrality, there can be a significant clash with the requirements of equity.

4.23 It may not be as difficult to reconcile the concepts of equity and efficiency as it would appear initially. There are two reasons for this. Firstly, quite simple measures on the public expenditure side can be used to offset the inequities caused by the indiscriminate impact of simple taxes. Secondly, and more importantly, a great deal depends on the precise degree of progressivity that is seen as necessary to achieve equity. What is important from the point of view of equity is the overall redistributive effect of Government expenditure and taxes. If some progressivity is achieved on the expenditure side of the account, the degree of progressivity in taxation can be reduced. The lower the degree of progressivity required from the tax system, the more the demands of equity and efficiency can be reconciled.

CHAPTER 5

INCIDENCE OF TAXATION

Introduction

5.1 In this chapter we consider the incidence of taxation, by which is meant the final distribution of the tax following the adjustment of economic behaviour after tax has been imposed. Our analysis suggests that, except in the case of agriculture and business in the unsheltered sector, there may be considerable scope for shifting of tax burdens in Ireland. Other sectors can pass on increases in taxation to the unsheltered sectors. This is reflected in either reduced profit or income in these sectors and/or increased unemployment. Over a period, the increasing uncompetitiveness in the unsheltered sectors may result in a devaluation of the currency, thereby shifting the burden of taxation back to the community through the resulting decline in living standards. This completes the circle, which may be repeated.

The Concept of Incidence

5.2 In Ireland, it is widely assumed that income tax rests on the income taxpayer and is not shifted forwards. For example, if a 60 per cent tax is placed on earnings over £20,000 per year and a 35 per cent tax put on earnings over £6,000 per year, then it is assumed that this causes redistribution (as compared to a proportional tax) by virtue of the "obvious" fact that those with higher incomes pay absolutely and proportionately more than those with lower incomes. In the case of indirect taxes, the assumption is that there is full shifting to consumers in the form of higher prices. If a tax of 10p is imposed on a pint of beer, it is assumed that the price of beer will increase by 10p and that the burden of this increase will be borne by consumers and not shifted by them to others. This is an oversimplified view as different sectors of the community may be in a position to shift the burden of taxation to others to varying degrees.

5.3 Taxes are paid initially by individual households or firms and their reaction sets in motion forces which determine the final incidence of the tax. Adjustments to a tax will cause factor (e.g. labour) and product prices to change and these changes will determine the distribution of the burden among households. Thus, the distribution of the real burden of the tax may

be different from the nominal burden imposed by legislation. For this reason, satisfactory answers to incidence questions are basic to any evaluation of possible tax reforms.

Pay Determination

5.4 In the market sector, it is labour costs, of which pay is an important determinant, which mainly decide the level of employment in that sector. A large part of the pay structure is set by collective bargaining and even pay in non-unionised sectors is influenced by the rates set in unionised sectors. The question is whether unions are able to shift an increase in taxation by demanding and obtaining higher pay and if this is done whether employers are able to pass on the resulting higher labour costs to the consumer. A summary of the experience in other countries is contained in Appendix 4.

5.5 The attempts by Irish Governments, in recent years, to use tax concessions to persuade employees to accept lower increases in pay than they would otherwise demand could have no rationale unless it were believed that employees would try to shift, and largely succeed in shifting, the burden of taxes by demanding and getting higher gross pay. In the supplementary budget in June, 1975, the Government introduced subsidies on certain basic items which were estimated to reduce the rise in the Consumer Price Index by four percentage points. As a result, an adjustment was made in the amount of the increase due under the third phase of the 1975 National Pay Agreement which was related to the change in the Consumer Price Index. The implementation of increases in personal income tax allowances announced in the 1977 Budget was conditional on "the draft national pay agreement (being) ratified by the parties concerned".[1] The National Understanding for Economic and Social Development, 1979 was designed

> "to ensure that the negotiations on the pay and conditions of employment of workers are an integral part of an overall economic and social plan which has been the subject of discussions between the Government, ICTU and Employers. These discussions have been concerned with measures for increasing national output, job creation, industrial peace and all factors which affect take-home pay of employees and labour cost of employers".

To this end it provided for tax concessions specifically for employees. Tax concessions for employees were also included in the 1980 National Understanding and it must be assumed that these were designed to persuade employees to accept an agreement which they might otherwise have

[1]Dáil Debates, 26 January, 1977, Vol. 296, Col. 266.

rejected. The tentative conclusion to be drawn is that there is reason to believe that employees seek to shift at least part of the burden of direct taxation forward to employers in the form of higher wage costs. In the exposed sector, employers may have difficulty in shifting these additional costs forward to the consumer.

5.6 The remuneration of executives at the upper end of the income scale is not determined through the collective bargaining process. Instead, it is influenced by movements in the salaries paid to executives at the lower end of the income scale and the need to maintain appropriate differentials between higher and lower paid executives. The differentials between the different levels of executives are usually determined by custom in the particular business and by market comparisons. Disturbances in the differentials tend to be triggered off as a result of executives at the lower end of the scale securing salary increases through the collective bargaining mechanism. Similar increases are then awarded to the higher paid executives in order to maintain internal relativities. In the public sector remuneration tends to follow the trend set in the private sector, although it, too, is subject to pressures to maintain internal relativities.

5.7 It appears that an important determinant of the level of pay rises is the increase in the Consumer Price Index. This includes any increase in retail prices arising from the imposition of indirect tax increases. This would suggest that employees may succeed in passing on the burden of indirect tax increases to employers in the form of higher pay. To hold that indirect taxes are not shifted would imply that changes in the Consumer Price Index were not taken into account in pay determination. It remains to determine the reaction of employers to these higher costs. This is considered, for convenience, under the heading of companies.

Companies

5.8 An analysis in the National Economic and Social Council Report *Prelude to Planning*[2] suggested that the economy could be classified into market and non-market sectors. The market sector is that in which goods and services are sold directly for money and is what we are concerned with here. Activities that fall within the market sector can be divided into two broad categories: firstly, those which are not sheltered from external competition and secondly, those which are sheltered from external competition. The unsheltered or exposed activities are those which are exporting and/or which have to face competition from imports in the home market. With the freeing of trade that has occurred since 1965, more of the activities in the market sector have moved into the unsheltered category. All exports

[2]*Prelude to Planning*, NESC Report, No. 26, October, 1976.

of goods and services and all goods and services which have to meet competition from imports are produced in the unsheltered part of the market sector.

5.9 The prices of the goods and services produced by the unsheltered activities are determined externally. If Irish wages and other costs (including taxation) rise faster than those in other countries, firms which are exporting or which have to compete with imports may not be able to pass on the full increases in higher prices. Their profits and profit margins are therefore squeezed. At best, the funds available for new investment are reduced so that less investment will occur, thereby reducing competitiveness in the longer term. At worst, the prices at which they can export, or at which they have to sell to compete with imports, no longer cover costs and the firms become unprofitable, can employ fewer workers and may be forced out of business.

5.10 Thus, we can say that in the case of the unsheltered activities, which consist mainly of agriculture and industry, taxation cannot be passed on to consumers in the form of higher prices and the burden of taxation in these circumstances must be borne by shareholders or employees. In the latter case, this may be in the form of lower wages and salaries and/or reduced levels of employment.

5.11 The sheltered activities in the market sector consist of those which do not export and which do not have to meet competition from imports in the home market. These activities mainly lie within the services sector of the economy. They include building and construction, the repair and maintenance of vehicles, all personal services, professional services, wholesale and retail distribution, transport, all public utilities and most of banking and finance. The prices of the services provided by these sectors are not determined externally, except to the extent that they encounter price resistance from the unsheltered sector seeking to cut costs. Nor are they in any direct way constrained by the level or behaviour of external prices: a person wanting a haircut or a house, for example, must buy it in Ireland. Within many of these sectors there may be intense competition in Ireland; for instance, this may be the case in retail distribution, especially in the larger urban centres. External firms may enter retail distribution here, but since they will incur the same domestic costs as the firms already established in the trade, the price they charge for their services will approximate towards that already ruling in Ireland. In some of these sectors; competition may be absent or limited: this is the case in almost all the professions where price competition is not generally permitted. In such cases the price charged for the service may be higher than it would be with competition. However, there would still be no direct external constraint on the charges that could be made.

5.12 Sheltered activities in the market sector are therefore in a quite different position from the unsheltered activities. The latter have little or no scope for raising their prices to compensate for a higher rate of increase in costs than is occurring elsewhere, because the prices obtainable in export markets and the prices of competing imports are externally determined. By contrast, the sheltered market activities suffer from no such constraint. Increases in their costs can be passed on in higher prices and their profit margins can usually be maintained subject to the normal price control machinery, where this applies. Ultimately, however, the higher costs will cause the unsheltered sector to be eroded which, in turn, will adversely affect the sheltered sector.

Agriculture

5.13 Under the EEC Common Agricultural Policy (CAP), prices are generally fixed at a higher level than would be maintained if market forces were allowed to prevail. Most of Irish agricultural output is covered by the CAP and the bulk of the remainder is subject to competition from imports. Domestic considerations in Ireland are unlikely to have more than a marginal impact on the price level fixed under the CAP. Thus, it appears that farmers in Ireland have little or no control over the prices they receive for their produce which implies that taxes paid by farmers are costs which are not shifted to the consumer in the form of higher prices.

Devaluation

5.14 The analysis to date suggests that taxes are ultimately shifted in the form of higher costs to the unsheltered sector. Over a period, this may result in certain parts of that sector becoming uncompetitive in both domestic and foreign markets. This increasing uncompetitiveness would manifest itself in higher levels of unemployment and a growing deficit in the balance of payments on current account. This, in turn, would result in a contraction in the tax base and an increase in Government expenditure. In the longer term, these forces could result in depreciation of the Irish pound.

5.15 Devaluation or depreciation leads to higher prices of imports and (to a lesser extent) exports, expressed in Irish pounds. These price increases would initially reduce real incomes and raise profits in export- and import-competing industry. Therefore, if the loss of competitiveness is due to a shifting of the burden of taxation to the unsheltered sector, this burden is then shifted back to other sectors through the higher price level caused by a devaluation. Devaluation of the Irish pound would tend to increase net exports, output and the domestic price level. It would also tend to improve the balance of payments and increase the share of profits in national income. However, if domestic incomes from employment were compen-

sated for this increase in prices, the domestic inflationary process would accelerate. The shifting of the burden towards the exposed sector would begin again and the advantages of depreciation would be lost.

Tax Capitalisation

5.16 In addition to being shifted forwards or backwards, taxes may be capitalised through their effect on the capital values of the assets which are subject to taxation. For example, the imposition of a tax on land may be expected to reduce the market value of the land by an amount equal to the present value of the expected future tax payments. Similarly, tax reliefs for investment in particular types of assets may be expected to increase the relative prices of these assets. For example, subsidies to encourage owner-occupation of housing may lead to an increase in the price of housing.

Conclusion

5.17 Our analysis suggests that, except in the case of agriculture and business in the unsheltered sector, there may be considerable scope for shifting of tax burdens in Ireland. Other sectors can pass on increases in taxation to the unsheltered sector. This is reflected in either reduced profit or income in that sector and/or increased unemployment. Over a period, the increasing uncompetitiveness in the unsheltered sector may result in a devaluation of the currency, thereby shifting the burden of taxation back to the community through the resulting decline in living standards. This completes the circle, which may be repeated.

CHAPTER 6

TAXATION AND THE DISTRIBUTION OF INCOME

Introduction

6.1 The question of the "correct degree" of progressivity is one of the most difficult issues in taxation policy. By "degree of progressivity" is meant the extent to which the tax burden increases more than proportionally with income. It is commonly believed that society is concerned about the distribution of income, that Government should effect some redistribution of income and that one of the most powerful methods of influencing income distribution is through the tax system. In this chapter we attempt to assess the extent to which redistribution of income occurs through the tax system.

The Approach

6.2 To deal with the issue of progressivity, it is necessary to compare the total taxes paid by individuals. The argument is properly concerned with the differences between the totals rather than the absolute amount of the totals themselves. In tackling this issue three steps must be taken:

(i) It is necessary to establish the facts of the present distribution of income in Ireland (a) gross and (b) net of taxes and social insurance payments. In other words, what are the overall income redistribution effects of the principal State taxes and benefits? The available statistical material is set out in Appendix 5. This comprises income distribution data compiled by the Revenue Commissioners from income tax returns, national accounts data on the functional distribution of income and information derived from Household Budget Surveys conducted by the Central Statistics Office.

(ii) If the situation revealed by (i) suggests a need to consider changes in the distribution of income, we must decide to what extent alterations in the tax system are capable of bringing them about and to what extent taxation policies, rather than other public policies, should be used to do this.

(iii) If the use of the tax system is one of the effective methods of meeting distributional objectives, these objectives must be established.

6.3 Care must be taken in interpreting the data presented in Appendix 5. These are subject to a number of limitations. The definition of income on which they are based is regressive in that it excludes certain items which accrue more than proportionately to persons in the higher income groups, but the effect of this is difficult to measure. In addition, the Household Budget data are based on the household unit which is unsatisfactory for taxation purposes because it does not coincide with the normal taxable unit. Further, the implicit assumptions about the incidence of taxation, particularly indirect taxation, are open to question.

Tax and non-Tax Policies in Redistribution

6.4 Even if the current distribution of income after tax could be assessed accurately and were judged to be satisfactory, it would still be necessary to consider whether the existing tax system is contributing to the result as simply and efficiently as possible. We must decide also whether or not the tax system is the most effective instrument for achieving distributional objectives or whether other instruments are to be preferred.

6.5 To the extent to which Government or other publicly controlled bodies directly regulate the relativity of gross incomes, the need for redistribution through the tax system or other instruments is reduced. Policies on monopolies, restrictive practices and employment are relevant in this context. Most of the expenditure on social services, even when it does not involve direct cash transfers, is clearly important in preventing extremes of poverty. The State's role in determining the participation of the population in education is most important. At the lower end of the scale, some persistent poverty may be attributed to failures in elementary education. Higher up the scale, much of the difference in earned incomes derives from the scarcity of skills that are costly to acquire in terms of time and money. In the longer term, education policy may be, perhaps, the most powerful weapon available to democratic Governments in seeking to reduce inequality in the distribution of incomes.

6.6 In considering the use of taxation as a redistributive measure, it is important to distinguish between the initial effect of a change in the progressivity of the tax structure and its effective incidence. An increase in progressivity through a change in personal income tax may be examined for illustrative purposes. Two types of permanent reaction have to be considered — gross income claims and evasion and avoidance.

6.7 In conditions such as those which operate in Ireland, where a high proportion of earned incomes is collectively determined with considerations of "fair relativities" very much to the fore and arguably predominant, it is at least conceivable that any attempt to change established differentials in real incomes may be defeated by countervailing adjustments in gross incomes. It is clear also that high marginal tax rates stimulate evasion and avoidance by increasing the returns to these activities. With a marginal tax rate of 80 per cent, £1 in tax-free income is equivalent to £5 in income which is subject to tax. Because opportunities for evasion and avoidance are not equally distributed, it is possible that nominally progressive systems result in more unequal distributions of disposable income than those which are nominally less progressive. These considerations suggest that a nominally progressive tax system may be a less powerful mechanism for achieving redistribution than is commonly supposed.

The Distributional Objective

6.8 It is extremely difficult to give objective advice on the desirability or otherwise of a change in the distribution of income and wealth in society. This problem is essentially and acutely political and ultimately must be decided by reference to political judgements. However, the question is implied under our terms of reference by the requirement to devise an equitable system of taxation.

6.9 As an initial step, it may be possible to achieve a consensus on the following general propositions. Taxes should be related to ability to pay having regard to family obligations but should not be so high as to affect seriously the incentives to work and generate wealth. Some limits on the excessive concentration of wealth are likely to have weak disincentive effects. On the other hand, the incentive to work can be weakened unless a sufficient part of the extra rewards given by the market to individuals for extra work or special skills are retained by them. The difficulty arises in translating such broad statements into quantitative terms. While there will be almost universal agreement that, overall, taxation should be progressive at the upper end of the scales of income or expenditure and wealth and that, at the other extreme, cases of special need should be relieved of taxation or assisted by income maintenance payments, there will be widespread disagreement about the precise degree of progressivity that should be adopted.

6.10 When such estimates as can be made are examined, it appears that the present system of taxation is approximately proportional over the middle band of income in which most people in Ireland spend most of their working lives. We believe that this is broadly acceptable to the public at large, provided it is supplemented by progressivity towards the top of the scale of income and wealth and relief at the other extreme.

CHAPTER 7

INFLATION AND TAXATION

Introduction

7.1 Inflation has serious implications for political and economic life. Taxation is no exception. It is clear both from submissions and from our analysis that inflation results in severe distortions in the tax system. In this chapter we examine these distortions. We conclude that the tax system should be neutral with respect to inflation. In later chapters we explore the implications of this principle.

Inflation in Ireland

7.2 In the nineteen fifties consumer prices, which are commonly treated as the main index of inflation, rose by over two-fifths. The increase in the nineteen sixties was over one-half. However, at the end of the seventies, prices were three and a half times higher than they were at the beginning of the decade.

7.3 Inflation on the scale experienced in recent years is gravely disturbing, especially when it is unanticipated. It produces arbitrary changes in the distribution of income and wealth, favouring debtors at the expense of creditors, the working population at the expense of those on fixed incomes and the more powerful pressure groups at the expense of less powerful ones. It distorts the pattern of production as some people no longer choose the goods and services they most want for consumption and the pattern of savings most suitable to their real needs but rather what will give them the best hedge against inflation. It creates uncertainty throughout the community, damages business confidence and leads to industrial unrest. To the extent that higher inflation in Ireland than in competing countries is not offset by changes in the exchange rate, competitiveness is lost, employment is reduced and balance of payments difficulties will follow. Inflation also discriminates against long-term investment by making investments with short pay-back periods more attractive. Once the rise in prices is at all rapid, there is a danger of further acceleration, which, if unchecked, results in higher inflation and a breakdown in the economic and social fabric of society, as competing groups try to maintain their relative positions.

7.4 Inflation also has important effects on a tax system. The Irish tax system was developed during a period in which stable prices were regarded as the norm. Since then various provisions have been added to the system to offset some of the effects of inflation but this has not been done on a systematic basis. As a result, inflation changes the overall level of taxation as a proportion of national income. It raises the share of particular taxes as a proportion of total tax revenue and reduces others. The impact of inflation on individual taxes affects different categories of persons in different ways. Most of these effects are arbitrary. For these reasons, there can be no question but that inflation exerts a powerful influence on the incidence of the Irish tax system. This must be analysed under the three headings of payment of tax, fiscal drag and the tax base.

Payment of Tax

7.5 With inflation at the levels experienced in Ireland in recent years, any appreciable delay between the event which gives rise to tax liability and the actual tax payment produces a significant reduction in the real burden of tax which is, in effect, paid in depreciated currency. Unless such delays can be exploited equally by all taxpayers, inequities will occur. If a realistic rate of interest is not charged and collected on the postponed amount, any delay in paying tax confers a benefit on the taxpayer

Fiscal Drag

7.6 Where a tax is levied at progressive rates or involves exemptions and deductions which remain unchanged in money terms, substantial increases in prices and incomes have the effect of increasing receipts from particular taxes faster than the general rate of inflation. This effect has come to be known as fiscal drag. In so far as fiscal drag applies to a major element of the tax system, it is inevitable that tax receipts will rise faster than gross domestic product at market prices. As the statistics in Chapter 1 indicate, total tax revenue has increased from 26 per cent of gross domestic product in 1965 to 38.3 per cent in 1981. While several factors have contributed to this upward trend, the tendency for inflation to push taxpayers into higher income tax brackets has been responsible in no small measure. The increase in personal income taxes has been responsible for 62.6 per cent of the increased share of taxation in gross domestic product. The windfall yield of income tax resulting from fiscal drag has been very attractive for Government in so far as extra revenue can be obtained without the odium of increasing tax rates by legislation. However, such illusions do not persist when people realise that, though their incomes are rising as fast or faster than prices, their incomes after tax are rising less quickly.

7.7 Since fiscal drag mainly concerns personal income tax, a further effect of inflation is to increase the proportion of tax revenue attributable to

income tax. In 1965, personal income taxes accounted for 17 per cent of total tax revenue. By 1981, this had increased to 31 per cent. Fiscal drag also affects the yield from stamp duties which increased as a percentage of total tax revenue from 1.0 per cent in 1965 to 1.7 per cent in 1981.

7.8 Even if a trend towards greater reliance on personal income tax were thought to be desirable, it is unlikely that inflation is achieving the restructuring at the right pace and in the right way. If the personal tax rates and allowances remain unchanged during a period of inflation, there is an increase in the average rate of tax at all levels of real income[1] subject to personal taxation. The rate of increase in average tax rates varies at different levels of real income thereby changing the distribution of taxation between income groups. The rate of increase in tax payable also varies for taxpayers with different numbers of dependants; those taxpayers with the largest number of dependants, generally speaking, are likely to experience the largest increase in average tax rates. These conclusions are supported by the figures in Table 9 which shows the percentage increase in tax liability which would have occured in Ireland at 1981/82 rates of tax if total income had risen by 10 per cent.

TABLE 9

Increase in Income Tax Liability in Ireland at 1981/82

Rates of Tax if Total Income Increased by 10 per cent.

Total Income	Single Persons		Married Persons with No Children		Married Persons with Three Children	
	Increase in tax payable		Increase in tax payable		Increase in tax payable	
£	£	%	£	%	£	%
2,000	120.00	0.0	—	—	—	—
3,000	105.00	18.8	-	—	—	—
4,000	140.00	15.4	240.00	0.0	240.00	0.0
5,000	175.00	13.9	300.00	50.0	175.00	31.0
6,000	258.00	16.1	210.00	18.8	210.00	23.0
7,000	315.00	15.8	245.00	16.7	245.00	19.4
8,000	378.00	15.5	280.00	15.4	280.00	17.3
9,000	495.00	16.9	315.00	14.5	315.00	16.0
10,000	569.25	16.3	675.00	13.9	350.00	15.1
15,000	900.00	13.9	675.00	15.2	675.00	16.1
20,000	1,200.00	12.7	1,138.50	16.3	1,109.25	16.7
50,000	3,000.00	10.9	3,000.00	12.0	3,000.00	12.2

Note: In the above table it is assumed that individuals qualify only for the basic single, married and child allowance.

[1]Real income is defined in terms of constant purchasing power.

For example, Table 9 shows that at an income level of £6,000 the tax liability of a single person increases by 16 per cent, that of a married person with no children by 19 per cent and that of a married person with three children by 23 per cent. The corresponding figures at an income level of £15,000 are 14 per cent, 15 per cent and 16 per cent respectively.

Inflation and Personal Income Tax

7.9 There are two basic mechanisms by which inflation results in a redistribution of the tax burden when a progressive income tax schedule remains unchanged. The first mechanism concerns the relationship between total income and taxable income (i.e. total income less personal allowances and reliefs). For any taxpayer entitled to allowances for dependants, inflation results in taxable income increasing more rapidly than total income. This reflects the fact that allowances for dependants are fixed in nominal terms. In a case in which real total income is unchanged, the proportion of total income subject to tax increases. For example, take the case where total income is £4,000 and allowances are £2,000. If inflation is running at an annual rate of 10 per cent, the equivalent real total income in the following year will be £4,400. Therefore, if allowances remain fixed, taxable income rises from £2,000 to £2,400 or from 50 per cent to 54.5 per cent of total income.

7.10 Even under a tax system with a flat rate of tax, this will result in increased average rates of tax for all taxpayers, since the marginal rate of tax exceeds the average rate, due to the effective exemption of the first slice of income through the granting of personal allowances. In the example given above, with a flat rate of tax of 20 per cent, the average rate of tax in year 1 is 10 per cent (tax equals £2,000 at 20 per cent = £400). The marginal rate of tax is 20 per cent and under an unindexed system, the average rate of tax will approach the marginal rate as money income increases.

7.11 For taxpayers with any given number of dependants, the proprortionate increase in taxable income, resulting from a given increase in total income, varies inversely with the initial level of total income. In other words, low income taxpayers experience the largest proportionate increase in taxable income because the amount of total deductions in respect of dependants is fixed in nominal terms. For example, a married man with total income of £4,000 and allowances of £2,000 has a taxable income of £2,000. A married man with three children and allowances of £3,000 has a taxable income of £1,000 at the same level of income. With inflation running at 10 per cent per annum, the equivalent real total income will be £4,400 in the following year. However, the taxable income of the married man will rise by 20 per cent to £2,400 compared with a rise of 40 per cent to £1,400 for the married man with three children. Hence, the elasticity of taxable

income to total income (that is, the proportionate increase in taxable income divided by the proportionate increase in total income) declines continuously as the level of total incomes rises and is independent of the rate of inflation. In addition, the higher the aggregate level of allowances in respect of dependants, the larger is the proportionate increase in taxable income for any given increase in total income. It follows that low income taxpayers with large families bear the largest proportionate increase in taxable income for any given proportionate increase in total income.

7.12 The second mechanism through which the combination of inflation and an unchanged structure results in a redistribution of the personal tax burden is found in the progressive rate scale. Under such a scale, except in the case of the first band of taxable income, any increase in taxable income generates a proportionately greater increase in tax liability. All of the increased taxable income is subject to a marginal rate of tax at least as high as the highest marginal rate payable on the initial level of taxable income. Consequently, even in a situation where taxable incomes increase at a rate equal to the rate of inflation (that is, where real taxable income remains constant and real total incomes fall) the purely nominal increase in taxable income results in an increased proportion of any given real level of taxable income being taxed at what was previously the highest applicable marginal rate of tax. The result is an increase in the real tax liability for each level of real taxable income. For example, a married couple with total income of £6,000 and allowances of £3,000 have a taxable income of £3,000. If inflation is 10 per cent, they require an increase of £300 (or 5 per cent) in total income to maintain their taxable income in real terms. At 1982/83 rates of tax in Ireland the position for a married couple would be as in Table 10.

TABLE 10

Effect of Inflation of 10 per cent on a Married Couple at 1982/83 Rates of Tax

	Before Inflation		After Inflation	
Rate of Tax	Amount of taxable income	% of taxable income charged at each rate	Amount of taxable income	% of taxable income charged at each rate
%	£	%	£	%
25	2,000	66.7	2,000	60.6
35	1,000	33.3	1,300	39.4

The increase in taxable income of £300 is chargeable at the existing marginal rate of 35 per cent, thus increasing effective rates of tax.

7.13 If nominal incomes do not rise at all in a period of inflation, average

rates of tax remain the same because the tax system is applied to nominal incomes. However, this does not alter the fact that the average rate of tax on every level of real income, for every dependent category, has increased. The real income of all taxpayers has declined but each taxpayer continues to be taxed at the same average rate of tax to which he was subject when his real income was higher.

7.14 If money income increases at a rate equal to the rate of inflation, the percentage increase in disposable money income is always less than the rate of inflation, since the marginal rate of tax always exceeds the average rate for any income level.[2] Real disposable incomes thus decline as a result of inflation.

Specific Taxes and Inflation

7.15 Excises are levied, normally, in terms of a specific monetary amount on a quantity of a commodity. For example, the excise on beer is levied as so many pounds per standard barrel (that is, 36 imperial gallons of worts at a specific gravity of 1055 degrees). An exception to this general rule is the excise duty on tobacco which, since 1978, is levied partly as a specific duty and partly as an *ad valorem* one. Other examples of specific taxes are motor vehicle duties and social insurance contributions before they were converted to pay-related contributions in 1979. In a period of inflation, both the real value of specific duties and the proportion of tax revenue obtained from them falls unless the rate of duty is raised specially to offset the effects of the rise in prices. When this is done, the increases are normally referred to as increases in taxation, when they are in fact measures required to stop taxes falling. As a result, in a period of rapid inflation, there may be a reluctance to impose the substantial nominal increases that are necessary merely to offset the effects of inflation.[3]

7.16 The substantial nominal increases in excise duties that are required merely to maintain the real value of the taxes in a period of rapid inflation cause some disruption to the manufacturers and traders in products subject to excises. The normal pattern is for a steep increase in the duties to be introduced on budget day followed by a year in which the real value of the duties declines steadily. This leads to anticipatory buying which may be subject to controls by the Revenue Commissioners, followed by a temporary slump in demand. The controls imposed by the Revenue Commissioners are of necessity rather crude since they are based on a quota system which makes little or no allowances for changes in the market share of

[2]This is true for almost any tax system. An exception, of course, would be in a case in which there was a ceiling on the proportion of income which could be taken in tax. In this case, the marginal and average rates of tax are equal once the ceiling is reached.

[3]B.M. Walsh, September, 1980, *Drinking in Ireland* ESRI Broadsheet, No. 20, p. 45.

particular companies. However, the Revenue Commissioners do have some discretion in the way the controls are implemented.

Inflation and Other Taxes

7.17 Capital acquisitions tax, like personal income tax, is a progressive levy. In the absence of offsetting adjustments to the scale of rates and the size of exemptions, the tax will bite into estates and gifts with ever increasing severity as rising prices cause money values to become inflated. Stamp duties levied on the conveyance of property (other than stocks or marketable securities) also have a progressive rate structure. As a result, the amount of tax paid increases in real terms unless there is adjustment of the rate structure to compensate for inflation.

7.18 The opposite effect is seen with pay-related social insurance contributions which are levied at a fixed percentage of pay up to a limit on the amount of the contribution. Unless this limit is raised regularly in line with inflation, a greater proportion of the population will be liable to the maximum rate of contribution thereby increasing the regressivity of the system.

The Tax Base

7.19 Under a system of proportional tax rates and even under a progressive system which is regularly adjusted to take account of price changes, inflation causes problems in the definition of the tax base. These problems figured prominently in submissions.

7.20 One of the most important of these problems concerns business income. The effect of inflation on the measurement of business income has been the subject of critical examination within the accountancy profession and among business management for some years. The fundamental problem is that, in periods of rapid inflation, profits determined on the basis of conventional accounting methods do not reflect "true" profits which are materially lower. These same methods, when employed for determining tax liability, may result in business income being taxed more heavily than may be justified. When this occurs, the viability of business suffers, "true" retained profits are reduced below the levels needed for continuing operations and organisations are forced to seek new investment funds in order to maintain the existing level of business. We discuss this problem further in Chapter 26.

7.21 Inflation also affects capital gains tax. If capital gains are charged to tax without adequate recognition of the fact that in a period of inflation a considerable proportion of such gains simply reflects the change in the general price level and does not reflect any increase in purchasing power,

a large capital levy may result. This fact is recognised in the existing capital gains tax legislation which endeavours to confine a charge to gains in real terms. Table 11 shows the amount of liability arising under a capital gains tax charged at the rate of 30 per cent with no allowance for inflation. The liability is expressed as a percentage of the realised value of the asset, the money value of which has risen in line with inflation and the real value of which has remained the same.

TABLE 11

Effect of Imposing 30 per cent Capital Gains Tax with No Allowance for Inflation where Capital Appreciates at the Same Rate as Inflation

Number of years before asset is realised	Tax as percentage of realised value of asset where annual rate of increase in general price level is		
	10 per cent	15 per cent	20 per cent
1	2.7	3.9	5.0
2	5.2	7.3	9.2
5	11.4	[illegible]	17.9
10	18.4	22.6	25.2
20	25.6	28.2	29.1

7.22 Inflation also has implications for the taxation of income from investments, particularly income from fixed-interest securities. When inflation accelerates, the real rate of return on fixed-interest assets declines and their real capital value falls. Borrowers gain at the expense of savers. For example, take the case of an individual who owns a 5 per cent irredeemable security of a nominal amount of £9,000. Suppose that the long-term rate of interest is 15 per cent, the rate of price inflation is 10 per cent a year and that the rate of interest and the rate of price inflation are expected to remain unchanged for the indefinite future. This means that the security will have a capital value of £3,000 and a nominal income of £450 of which £300 will be required to maintain the value of the capital intact. If the rate of inflation increases to 20 per cent in the following year and interest rates also increase to 20 per cent, the capital value of the security will decline to £2,250 in money terms and £1,800 in real terms. The nominal income will still be £450 but this will be required to maintain the total capital value of £2,250 in real terms. The adjustments required in this area to establish an equitable tax base are closely related to the appropriate treatment of business income and capital gains.

7.23 Inflation creates special problems when it becomes necessary to compare values of items of property in different years. Similar problems arise in relation to the aggregation of amounts expressed in money terms which have been established at different times. For example, a decline in the value of money means that business losses are worth less when applied

as an offset to income of future years and worth more when offset against the income of earlier years.

Conclusion

7.24 The income redistribution consequences of inflation are arbitrary. Those on fixed incomes see their standard of living fall rapidly, while those in employment at least tend to maintain their position. Those who receive their incomes on a regular basis are better protected than those who only receive their incomes after long time lags. These effects are totally unplanned and tend to result in situations which would be impossible to justify under normal conditions. Inflation also affects the taxation system itself in an equally haphazard manner. Some taxes are reduced and others are increased. These effects are most important under a progressive income tax. Broadly speaking, the effect of inflation coupled with progressive tax rates is to increase tax liabilities at each income level to an extent that depends on the rate of increase in tax rates at that income. As a result, increases in average rates of income tax resulting from inflation tend to be greatest not at income levels where the marginal rates of tax are highest but rather at income levels where marginal tax rates are increasing most rapidly. For taxpayers who remain at the same marginal rate of tax during inflation, real incomes also tend to fall but by successively smaller percentage amounts as the level of taxable income rises.

7.25 The present Irish tax system was developed in a period in which stable prices were thought to be the norm. In response to the rapid acceleration in inflation in the early seventies, certain reliefs were introduced to mitigate the effects of inflation on taxation but this has not been done on a systematic basis. We believe that this failure to deal systematically with inflation adversely affects the equity of the tax system. It reduces the attractiveness of productive investment in favour of assets which have a scarcity value. Changes in the distribution of the weight of taxation which might be unacceptable if they had to be specifically identified and debated in the Oireachtas may pass through unnoticed. For these reasons, we are firmly of the opinion that, in principle, the tax system should be neutral with respect to inflation. The implications of following this principle will be identified when individual taxes are being considered.

Recommendation

7.26 We make the following recommendation:

1. The tax system should be neutral with respect to inflation.

Part II

Direct Taxation

CHAPTER 8

THE DEFINITION OF THE TAX BASE

Introduction

8.1 In this chapter we consider the tax base that should be adopted for purposes of direct taxation. We conclude that the tax base should be defined on a comprehensive basis to include all real increases in the command over economic resources. We also consider whether or not the base for personal direct taxation should be the aggregate amount of income received or expenditure made by each individual or tax unit. We conclude that a tax on income, as we define it, is preferable and should remain the main source of direct taxation in Ireland.

Equity Principles

8.2 Equity demands that taxation be levied in accordance with ability to pay. The notion that persons in equal situations should pay the same tax implies that tax is a sacrifice levied upon some kind of private "economic well-being". For practical purposes both the "sacrifice" by way of tax and the "well-being" upon which the tax is levied have to be measured in money terms.

8.3 Equity between persons cannot be secured — however finely the effective rate of tax is graduated according to an individual's total income for tax purposes and however meticulously it is differentiated to allow for personal circumstances — unless the tax base provides a measure which is uniform, comprehensive and capable of consistent application to all individuals. Impartial assessment of the relative taxable capacity of individuals is impossible if the tax base is unduly restricted, ambiguous or biased in favour of particular groups of taxpayers.

Present Definition of Income

8.4 The current legal definition of what constitutes income for income tax purposes has been reached by a process of piecemeal statutory revision and judicial interpretation of the Tax Acts. The Income Tax Act of 1803

originally categorised income under five schedules (two of which have since been repealed and another added) and these collectively defined the limits of taxable income. This structure is still broadly intact in present legislation. The original Act included a "sweeping-up clause" which is now Case IV of Schedule D, under which "any annual profit or gain" is taxable which is not enumerated under any of the other Cases or Schedules. Since the law employs the terms "income", "profit" and "gain" interchangeably, recourse has had to be made to the Courts to clarify what is chargeable and what is not. The difficulty inherent in doing this may be illustrated by the comparison of two well-known judicial interpretations of the statute. "Income tax", according to Lord MacNaughten's famous dictum, "is a tax on income".[1] As regards the word "income", Lord Wrenbury said, "it means such income as is within the Act taxable under the Act".[2]

8.5 Two influential notions have guided judicial interpretation in this area over the years. There has been a tendency in English (and Irish) cases to use the "fruit of the tree" concept of income — the old idea of income as something which recurrently emerges and is separated from its perpetual source. This concept was refined gradually by the introduction of allowances for capital wastage. A further boundary line, afforded by the idea that income is something which accrues regularly, has been discarded in judicial decisions which have established that casual or isolated gains are taxable provided that they are not of the character of "capital profits". There can be no doubt that the definition of income for tax purposes is neither clear nor consistent.

A Comprehensive Definition of Income

8.6 There is a difference between the legal approach to this problem, which seeks to refine and extend the everyday meaning of income, and the approach which defines income on a comprehensive basis. An influential contribution to the discussion of this topic has been that made by H. C. Simons. Simons[3] states that personal income broadly connotes the exercise of control over the use of society's scarce resources. Its calculation implies making an estimate of

(i) the amount by which the value of property rights would have increased between the beginning and the end of a period, if nothing had been consumed (destroyed), or

(ii) the value of rights which might have been exercised in consumption without altering the value of the store of rights.

In simple terms, it implies measuring consumption and accumulation.

[1] *London County Council v. Attorney General*, 1901.
[2] *Whitney v. Inland Revenue Commissioners*, 1926.
[3] H. C. Simons: *Personal Income Taxation*, 1938.

8.7 A comprehensive definition of income on these lines would include capital gains, bequests and gifts received, lottery and casual gambling winnings, compensation payments for loss of office and non-money income. The inclusion of these receipts in an income tax base would eliminate the need for separate taxes on estates, gifts, inheritances and capital gains.

8.8 This approach may be justified on the basis that the taxable capacity of an individual is his ability to attain a particular standard of living. On this basis, the test to be applied in deciding whether any particular item should or should not be regarded as income for tax purposes is whether and to what extent it contributes to spending power during a period. When set beside this standard, most of the principles that have been applied by the Courts at various times to determine whether particular items constitute income are largely irrelevant. It may be argued that no concept of income can be really equitable that falls short of the comprehensive definition which embraces all increases in the command over the use of society's scarce resources—in other words, the "net accretion of economic power between two points in time". This was the approach adopted by the Carter Commission in Canada which justified its view in the following terms:

> "We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals and families. If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power or it fell into his lap without effort. All of these considerations should be ignored either because they are impossible to determine objectively in practice or because they are irrelevant in principle, or both. By adopting a base that measures changes in the power, whether exercised or not, to consume goods and services we obtain certainty, consistency and equity"[4].

Inflation and the Definition of the Tax Base

8.9 The Simons definition of income was constructed at a time when

[4] *Report of the Royal Commission on Taxation*, 1966. Vol. 1 pp 9-10.

inflation was at much lower levels than it is today. As a result, it requires to be modified to take account of the effects of inflation. We have decided that the most equitable definition of the tax base is an amount which may be spent on consumption without adding to or subtracting from wealth in the process. Since we think in real rather than in nominal money terms, the proviso to the above definition must be amended to "without adding to or subtracting from real wealth in the process". To accord with the principle of neutrality with respect to inflation, which we adopted in Chapter 7, and to arrive at a proper base for taxation in inflationary conditions, an adjustment must be made to income to take account of the change in the real value of wealth due to inflation.

8.10 The case in equity for making this adjustment has been underlined by a study[5] of the Irish National Debt which has shown that in the years from 1969 to 1977 the holders of Irish Government securities obtained negative real rates of interest after taking account of the effects of inflation. This has produced two notable distributional effects. Firstly, wealth has been redistributed from the holder of monetary assets to the holder of monetary liabilities which, in the case of Government debt, is the general taxpayer. Secondly, the tax system has discriminated against lenders by failing to differentiate between interest income which maintains the real value of principal and that which adds to net worth. The author concludes that

> "there is little merit in these indiscriminate and irregular forms of redistribution. Many who could ill afford it suffered a loss, often in faithful response to Government appeals. The fact that a large proportion of public debt is held in financial institutions does not alleviate the loss on savers. It filters back to the holders of deposits or insurance contracts . . . . . The only redeeming feature is that these institutions probably serve to spread the loss more evenly through the population".

8.11 The operation of the adjustment to take account of inflation is illustrated by the following example. Consider A who has invested £1,000 in Government securities on which he is paid £160 each year, and ends up with an unchanged sum of £1,000 which has an unchanged real value. But if prices rise by 10 per cent in the course of a year, he must end up with capital of £1,100 in order to have maintained the real value of his capital intact. Of his interest of £160 he must save £100 to maintain his real capital. After adjustment for inflation, A's income, under a definition of income which is neutral with respect to inflation, is only £60.

8.12 Adjustment for inflation operates in reverse in the case of B who borrows £1,000 at 18 per cent. During the year he pays money interest of

[5]Richard Bruton, July 1978, *Irish Public Debt* ESRI Paper, No. 94, Page 76.

£180. If he repays none of the capital, he will still owe £1,000 at the end of the year which, if prices rise by 10 per cent, represents a decrease of £100 in his real debt. His net real capital wealth (after the deduction of the real debt) rises by this amount. Of the £180 paid in interest only £80 is a cost against real income; the other £100 is offset by a real addition to income which is saved and used to reduce real indebtedness.

8.13 A further example, where a distinction between real and money income is called for, concerns capital gains. Suppose an individual owns ordinary shares that have increased in value by 20 per cent. If the general level of prices has risen by 10 per cent over the same period, then the first 10 per cent in the appreciation of shares is needed in order to maintain the real value of the capital. Only the remaining 10 per cent is a genuine accretion which would come within our definition of the tax base.

Implementation

8.14 In applying the notion of a comprehensive tax base to any workable and acceptable tax system, two guiding principles may be considered.

8.15 Firstly, the use of a comprehensive definition of the tax base under a system in which tax is levied on an annual basis at progressive rates causes problems. This is because "bunching" of such windfalls as inheritances, winnings from gambling and gifts is likely to be widespread. It is obvious that to apply the progressive rates of an annual tax to receipts which typically accrue so irregularly over time would be inequitable. However, it is also inequitable to ignore such receipts altogether. The problems of bunching may be ameliorated by the introduction of averaging or by introducing separate taxes to deal with receipts which tend to accrue most irregularly.

8.16 A second guiding principle concerns certain types of benefits which cannot reasonably be brought within the scope of taxation because their control and enforcement is beyond the power of any efficient tax administration. To deal with these, it may be necessary to apply rough and ready rules to estimate the value of the benefits in the interests of simplicity. This would be more equitable than ignoring the benefits entirely.

Direct Expenditure Tax

8.17 An alternative to taking income (widely defined) as the base for personal taxation is to take expenditure or consumption. It is important to distinguish between the notion of a direct expenditure tax and that of indirect taxes on expenditure such as value-added tax or excise duties. The main distinction between these two forms of taxation is that, in determining liability to an expenditure tax, it is the aggregate amount of expenditure during the accounting period which determines the liability, whereas in the

case of indirect taxes the tax payable on a particular item is unaffected by an individual's personal circumstances or the amount of his expenditure on other items.

8.18 Advocates of a direct expenditure tax argue that it would eliminate the double taxation of savings which, they believe, is a weakness inherent in any income tax system. Thus, savings are financed out of taxed income but the yield from that investment suffers income tax.

8.19 Another attraction of a direct expenditure tax in the eyes of some of its proponents is that, by concentrating on the spending end of a taxpayer's affairs, the tax system has less need of complicated legislation designed to prevent income being dressed up as capital or *vice versa*. A direct expenditure tax treats all accretions to a taxpayer, whether from ordinary income, capital gains, gifts, inheritances or other receipts, in the same way. If the taxpayer spends the money, then liability will arise. If he saves it, no tax is due.

8.20 It is also claimed that inflation is less of a problem with a direct expenditure tax than with an income tax. Adjustments of tax thresholds and bands would still be needed. However, the need does not arise for capital/income adjustments to take account of the erosion of the value of capital by inflation.

8.21 There would be great practical difficulties in completely replacing income tax with a direct expenditure tax. At present, only a fraction of income taxpayers are required to complete an annual return of income. To administer a direct expenditure tax more returns and more detailed information in these returns would be required. This would increase private compliance costs and also the Revenue Commissioners would find it very difficult to cope with the additional work.

8.22 Whatever the theoretical attractions of a direct expenditure tax, we have concluded that the complete replacement of income tax by a direct expenditure tax is not a practicable proposition in the foreseeable future. We also believe that a tax on a comprehensive income base is the most equitable system of taxation. Therefore, income tax must remain as the mainstay of our system of direct taxation. However, we do recommend that income tax at the higher rates be replaced by a progressive direct expenditure tax.

Conclusion

8.23 The basic idea of a comprehensive income tax base is to tax opportunities (the accretion of economic spending power) rather than the actual use of such opportunities which may be better measured by consumption expenditure. One of the aims of a comprehensive tax base is to promote

horizontal equity by taxing all kinds of accretions of economic power equally; individuals with the same increased command over economic resources would then be treated in the same way regardless of the form in which this accrued. Thus, resources are saved which would otherwise be wasted by attempts to convert one kind of income into another in circumstances where different kinds of income were taxed at different rates (e.g. dividends and capital gains). A comprehensive tax base would be larger than the current income tax base and would enable the same revenue to be raised with reduced income tax rates.

8.24 Because of the problem of bunching, it is impracticable to apply steeply progressive rates to a comprehensive tax base. If it is desired to charge income tax at progressive rates, the bunching problem must be tackled either by introducing satisfactory averaging provisions or by introducing separate taxes to deal with receipts which accrue irregularly. The advantages arising from the adoption of a comprehensive income tax base can only be fully realised when tax is levied at a single rate.

8.25 Therefore, we recommend that the income tax base be extended to include very kind of income and gain. This is only possible if two conditions are satisfied. Firstly, the single rate of tax to be applied to the base cannot exceed a level generally perceived to be acceptable. Secondly, progressivity of the direct tax system must be introduced through a supplementary system of higher taxation, namely, a direct expenditure tax levied at progressive rates.

Part IIA

The Taxation of Individuals

CHAPTER 9

PRESENT INCOME TAX SYSTEM IN IRELAND

Introduction

9.1 The development of the Irish tax system was outlined in Chapter 1. Here we describe briefly the main provisions of the existing income tax system, set in its historical context.

Present System

9.2 Income tax is charged for a year of assessment beginning on 6 April

9.3 An individual who is resident, ordinarily resident and domiciled in Ireland is subject to this tax in respect of his total income, wherever arising. Further, income arising in Ireland is subject to income tax, irrespective of the residence or domicile of the recipient. There are exemptions from, and exceptions to, these general principles occasioned, *inter alia*, by the operation of double taxation agreements with other countries or by the provisions of the Corporation Tax Act, 1976.

9.4 For income tax purposes, income is classified under certain heads or schedules. The four schedules now existing deal with interest (taxed at source) on certain Government and other securities (Schedule C), income from self-employment, rents or investments (Schedule D), income from an office, employment or pension (Schedule E) and income from distributions received on or after 6 April, 1976 from a resident company (Schedule F).

9.5 Schedule D is sub-divided into five Cases:

Case I—Income from any trade, income arising out of lands, tenements and hereditaments in the case of mines or quarries.

Case II—Income from professions.

Case III—Certain dividends and interest which have not been taxed at source or under Schedule C, income from foreign securities and income from other foreign sources.

Case IV—Income not falling under one of the other Schedules or Cases.

Case V—Income from rents, premiums on leases and easements in respect of any land or premises.

9.6 For individuals, income tax is graduated by means of various allowances, deductions, reliefs and rates of charge. The allowances and deductions depend on the personal circumstances of the taxpayer, and, in effect, exempt the first slice of income. The amount of allowances and other reliefs is deducted from total income in arriving at taxable income.

9.7 Income realised by individuals in the form of capital gains prior to 26 March, 1982 is subject to a separate tax at the rate of 30 per cent. The rate of charge is reduced, depending on the period of ownership of the asset, leading to total exemption after 21 years (except in the case of gains arising on the sale of development land). In computing the tax chargeable, the amount of allowable expenditure (such as the cost of the asset and expenditure which enhances its value) is increased by reference to changes in the Consumer Price Index.

9.8 Proposals for changes in the capital gains tax legislation are included in the Finance Bill, 1982. It is intended that these will apply with effect from 26 March, 1982. The tapering relief will be abolished and the normal rate of tax will be increased to 40 per cent. Nominal gains realised within one year of acquisition will be charged at 60 per cent and real gains realised within two or three years of acquisition at 50 per cent.

Historical Background

9.9 The present structure of income tax has evolved over the past 180 years. Many of its principal features were introduced in the last century in Britain for reasons that may no longer be relevant in Ireland. For this reason, it is useful to examine briefly the historical development of the system.

9.10 Income tax was introduced in Britain in 1799 by William Pitt. This tax was an administrative failure and was repealed following the Treaty of Amiens in 1802. Addington reintroduced income tax in 1803 and it remained until 1816 when it was discontinued. No attempt was made to extend it to Ireland at that stage.

9.11 To meet the criticism that Pitt's Act gave a person reading a return of income too much information about a taxpayer's total income and was

a great intrusion into his private affairs, Addington introduced the famous five Schedules A to E which have survived to modern times. He also adopted the mechanism of deduction at source.

9.12 Peel reintroduced income tax in 1842 and the tax was extended to Ireland for the first time in 1853 by Gladstone. In 1907, Asquith introduced earned income relief, while in 1909 Lloyd George accepted the principle of graduation by introducing a sur-tax. Thus, between 1906 and 1918, income tax changed out of all recognition and developed the structure which, broadly speaking, it has retained to the present day. In 1906, it was a tax with a uniform rate of 5 per cent with exemption up to an income of £160. By 1918, it had admitted both differentiation in the form of earned income relief and graduation in the form of a sur-tax, with income tax rates rising to 30 per cent and the sur-tax to 22.5 per cent. Against these increasing burdens should be set the allowances introduced for married persons, children, housekeeper and dependent relatives.

9.13 Following independence in 1922, the income tax system inherited from Britain remained essentially the same. Many changes made in the British code were frequently followed by similar changes here, although the Irish system has deviated from the British in some respects.

9.14 After the Second World War, the use of the income tax system as an instrument to encourage developments which were considered desirable slowly gathered momentum. In 1946, relief was given in respect of expenditure incurred on scientific research. Life assurance relief was increased on Irish policies in 1953 and relief for medical insurance premiums was introduced in 1955.

9.15 Industrialisation was fostered initially by a policy of protection of home manufacture. This policy led to a considerable increase in industrial employment but, and by the middle of the nineteen fifties, it had become apparent that it offered little scope for further expansion. From then on the use of the tax system as an instrument to encourage economic development increased very markedly. In 1956, profits from increased export sales of Irish manufactured goods were completely relieved from tax. Wear and tear allowances were modified to encourage capital investment. After 1956, accelerated depreciation allowances were introduced and these were increased and extended in later years.

9.16 In 1969, the tax charges under Schedule A in respect of the ownership of property and under Schedule B in respect of the occupation of land were abolished.

9.17 The Finance Act, 1974 made a major change in the structure of

income tax by introducing a new unified system of personal income taxation. The new system involved

(i) abolition of earned income relief which was accompanied by an increase in the personal allowances and the introduction of a reduced rate of charge on the first band of taxable income, and

(ii) application of higher rates of income tax instead of a separate charge to sur-tax.

Farming profits were also charged to tax where the rateable valuation of all farm land occupied amounted to £100 or more. This threshold was reduced in later years and now stands at £40. A capital gains tax was introduced on gains realised on or after 6 April, 1974.

Conclusion

9.18 Income tax only became a factor in the lives of most employees in the nineteen sixties. The number of taxpayers has more than trebled since then. This growth is attributable to rising real incomes but mainly to a failure to increase tax thresholds in line with inflation. As a result, income tax now affects about four out of five income earners in Ireland. For this reason, public perceptions of the equity of the system are of far greater importance than was the case twenty years ago when the system was studied by the Commission on Income Taxation.

CHAPTER 10

THE WIDENING OF THE INCOME TAX BASE

Introduction

10.1 In this chapter we begin the detailed recommendations concerning changes in the existing income tax base in Ireland. These flow from our concept of income, defined in Chapter 8, as the amount which may be spent on consumption without adding to or subtracting from real wealth in the process. These recommendations are made in the context of a single rate of income tax proposed in Chapter 17. The amount of income exempted under specific provisions is set out in Appendix 6.

10.2 The discussion in this chapter is divided into three sections as follows:

(i) The taxation of imputed income,

(ii) Exempt income, and

(iii) Deductions from income.

THE TAXATION OF IMPUTED INCOME

10.3 In principle, the imputed income from a wide range of durable consumer goods comes within our definition of income. This would mean that the net annual rental income implicit in the ownership and personal use of such items as houses, furniture, cars, boats and other consumer durables would be included in annual income for tax purposes. We do not propose that this be done because of the administrative problems involved. However, we acknowledge the principle and note that the exclusion of these items may result in inequities between different classes of taxpayers. Because housing is of much greater value than personal chattels, we consider the taxation of housing in some detail.

Housing

10.4 The market for dwelling houses is so distorted by various State interventions and regulations (including special tax provisions) that changes in the tax treatment of housing require careful consideration. The tax provisions in relation to the acquisition and owner-occupation of housing are widely seen as being very favourable. We received a significant number

of submissions which drew attention to the relative treatment of owned and rented accommodation and which suggested eliminating the distortions in the tax system in this area.

10.5 We noted in Chapter 5 that tax reliefs for investment in particular types of assets may be expected to increase the relative prices of the assets in question in addition to increasing investment in them. Between the first quarter of 1973 and the third quarter of 1981 the prices of private new houses grew 38 per cent faster than consumer prices in general. The loans approved by all lending agencies rose from £88.8 million in 1973 to £411.4 million in 1980. By reference to the increase in new house prices, this represented an increase in real terms of 21.6 per cent.[1]

10.6 Table 12 shows capital formation in housing as a percentage of gross domestic fixed capital formation and gross domestic product between 1973 and 1979.

TABLE 12

Capital Formation in Housing

Year	Capital Formation in Housing	As Percentage of Gross Domestic Fixed Capital Formation	As Percentage of Gross Domestic Product
	£m	%	%
1973	150	22.9	5.6
1974	203	27.0	6.8
1975	210	24.1	5.6
1976	252	22.6	5.5
1977	304	21.4	5.5
1978	401	21.9	6.2
1979	541	22.8	7.2

Source: National Income and Expenditure.

10.7 The attractiveness of investing in housing in recent years may be shown by the following example. The average price of a new house bought in 1976 with the aid of a building society loan was £12,113. The corresponding figure in 1980 was almost £28,000.[2] If we assume that the purchase of the house was financed by a loan of £9,000 and the balance of £3,113 from personal savings, the return on the original equity investment, which is a tax-free capital gain of about £16,000, represents an average of over 120 per

[1]The figures in this paragraph are taken from the Quarterly Bulletin of Housing Statistics for Quarter ended 31 September, 1981. Department of Environment.

[2]The houses concerned are not necessarily comparable from year to year.

cent per year over the four-year period. To enjoy this rate of return, taxpayers would have had to borrow at negative real rates of interest. For example, in 1980 a taxpayer liable at 35 per cent could have borrowed from a building society at an effective real rate of interest of minus 9 per cent.

Categories of Housing

10.8 There are three major categories of dwelling house tenures, namely,

(i) owner-occupied houses,

(ii) rented houses owned by local authorities, and

(iii) rented houses owned by private landlords.

These three categories account for about 76 per cent, 12 per cent and 10 per cent of the Irish housing stock respectively.

Owner-occupied Housing

10.9 Owner-occupied houses are not subject to any tax on their annual value although they are, as it were, houses which the owner as private landlord rents out to himself as tenant. Consider three people, each with £40,000 to invest and wishing to live in a £40,000 house. We assume that the return on all capital is 5 per cent. R decides to rent and invest his money in shares. As shown in Table 13, he receives £2,000 in dividends. Assuming a rate of tax of 35 per cent, he pays tax of £700. O decides to buy his house outright and pays £40,000 in cash. He buys no shares and receives no dividend income but benefits from imputed rent of £2,000. Since this is not counted as taxable income, he pays no tax. M buys a £40,000 residence by taking out a mortgage, while using the £40,000 to buy shares. He receives

TABLE 13

Comparisons of Tax Treatment of Renter, Equity Owner and Mortgage Owner of House

	Renter R	Equity Owner O	Mortgage Owner M
	£	£	£
1. Owner's imputed rent	0	2,000	2,000
2. Interest paid	0	0	2,000
3. Dividends	2,000	0	2,000
4. Taxable under present law at 35 per cent	2,000	0	0
5. Tax under present law	700	0	0
6. Tax under Scheme 1	700	0	700
7. Tax under Scheme 2	700	700	700
8. Tax under Scheme 3	0	0	0

£2,000 in interest. Since mortgage interest may be deducted in computing taxable income he has no addition to his taxable income. We compare the three in line 5 of Table 13. They all have the same net worth and live in similar houses, but R pays £700 in tax, while O and M pay no tax. The problem is to determine how the three can be placed in an equal position. Removal of the interest deduction (Scheme 1) would not do. While M would lose his advantage and be placed in the same position as R, O would remain free of tax. In order to treat all alike, imputed rent would have to be charged to tax while a deduction for interest would continue to be allowed (Scheme 2). Alternatively, imputed rent could be disregarded and a deduction given for interest and for payments of rent as well (Scheme 3). Under Scheme 2, all would pay the same tax while under Scheme 3 none would pay tax. Both solutions would be neutral as between the various types of housing tenure. However, Scheme 3 would favour expenditure on housing while Scheme 2 would be neutral between expenditure on housing and other expenditure. Scheme 2 clearly offers the best solution. In principle, equal treatment should apply not only to people who use different forms of housing but also between those who choose to spend a high proportion of their income on housing and others who prefer to consume different items.

Local Authority Housing

10.10 Local authority houses are subsidised and generally let at rents which are considerably lower than those which would be necessary to yield a normal market rate of return on the capital values at which they would sell in the market. Special purchase schemes also apply to local authority houses. Details of these arrangements are set out in Appendix 7.

Privately-rented Housing

10.11 Houses rented out by private landlords may be subject to rent controls with security of tenure for the existing tenants, with the result that such houses have a market value considerably lower than that of similar houses for sale with vacant possession.[3] Rents for such houses are thus kept down but not (as in the case of local authority houses) by a State subsidy. On the contrary, the landlord pays the full rate of tax on the rent which he

[3]The Rent Restrictions Acts 1960 and 1967 were found by the Supreme Court to be unconstitutional. These Acts were replaced by the Housing (Private Rented Dwellings) Bill, which after being passed by the Dáil and Seanad was referred by the President to the Supreme Court to test its constitutionality. The Supreme Court ruled that this Bill was also unconstitutonal. The Rent Restrictions (Temporary Provisions) (Continuance) Bill was passed by the Oireachtas to give continued protection to tenants until 25 July, 1982 pending the introduction of new legislation. The Housing (Private Rented Dwellings) Bill, 1982 was signed by the President on 21 May, 1982 but is unlikely to come into effect until 25 July, 1982.

receives but the Exchequer loses tax revenue in so far as the landlord does not receive a full market rent. These arrangements result in an unwillingness of existing tenants to move. Rented accommodation which is not subject to rent control does not cause any distortion in the market for housing, though the existence of controlled rents may make uncontrolled rents higher than they otherwise would be.

Historical Background

10.12 Prior to 1969/70, income from the ownership of buildings was charged to tax on a notional basis — either on five-fourths of the rateable valuation under the Valuation Acts or the valuation itself, less, in certain circumstances, a small fraction for "repairs". This income was charged under Schedule A of the Income Tax Acts, which covered not only the income derived from letting property but also income imputed to the owner-occupier of property or to an occupier who held the property at a rent less than the annual value. However, the full amount of the assessment on premises was allowed as a deduction in arriving at the profits of a trade carried on in the premises.

10.13 The question of taxation under Schedule A was considered by the Commission on Income Taxation in its Second Report.[4] The Commission recommended that premises exceeding £30 valuation should be exempted in respect of the first £30 valuation. The Commission, in arriving at this conclusion, was influenced mainly by the arguments that

(i) real income did not arise from owner-occupation and notional income was not a proper subject for taxation;

(ii) if there was a charge on notional income it should not be confined to real property but should extend to chattel property also, such as furniture and jewellery, and

(iii) valuations of property were not uniform throughout the country and inequities resulted from using valuations under the Valuation Acts as a measure of "income" for tax purposes.

10.14 The Government's response to the Commission's recommendations regarding Schedule A was contained in the Second White Paper on Direct Taxation.[5] This contended that the argument at (i) scarcely took sufficient account of the principle that tax should be adjusted to capacity to pay. Accommodation was an essential of life. The owner-occupier enjoyed a very real financial benefit as compared with the taxpayer of equal income who was subject to the inescapable burden of rent. It was this benefit, derived from the capital invested in the purchase of a house, which was taxed under Schedule A.

[4]Prl. 5119, June 1959, paragraphs 99 to 110.
[5]Prl. 7024, April, 1963, paragraphs 15 to 31.

10.15 In dealing with the argument at (ii), the White Paper stated that a man's house was, generally speaking, of much greater value that his chattels and the difficulty of taxing the annual value attributable to such chattels did not invalidate the charge on residential property. In other words, the exemption of chattels was justified primarily on the grounds of the administrative difficulty of taxing the notional income arising from them. Finally, it was stated that the attribution of notional income to owner-occupation of residential property was not unique to Ireland. Provisions akin to it existed in other countries.

Abolition of Schedule A

10.16 Schedule A tax was abolished by the Finance Act, 1969 for 1969/70 and subsequent years of assessment. The reason for this was given by the Minister for Finance in his budget statement on 23 April, 1968 when he said

> "I have received representations from many sources to raise the various personal income tax allowances. Even a moderate general increase would cost many millions of pounds and could only be considered in relation to . . . a general review of our tax structure . . . pending any such change I have sought around for ways of giving relief in specially desirable directions at reasonable cost. It seemed to me that the abolition of tax under Schedule A would give just such relief. The tax falls mainly on the owner-occupier of a private residence and its abolition should give wide relief and be especially welcome to old persons living on pensions or fixed incomes as well as the general body of householders".[6]

10.17 The important point to note is that the abolition of tax on the notional income from owner-occupation was not justified on grounds of principle but rather was due to the fact that it was a convenient and cheap method of giving tax relief.

Rates Relief on Domestic Property

10.18 In theory, rates were a levy on the rental value of property. In the case of owner-occupied property, the tax base, as laid down in the Valuation Acts, was essentially the imputed rental income of the property. Before rates on domestic property were removed in 1978, they attracted considerable public criticism. Firstly, there was grave dissatisfaction with the equity of the valuation system, which had never been revised on a general basis, despite recommendations that this be done in a number of reviews of the rating system. Secondly, rates were criticised on the grounds that they were regressive. The fact that rates were also generally payable in two

[6]Dáil Debates, Official Report, Vol. 234, Col. 60.

relatively large lump sums contributed to their unpopularity. The only really satisfactory solution to the reform of the rating system was a general revaluation of property. This would have taken eight years to complete and would have been a complex and costly operation. In the circumstances, the view was taken that the most satisfactory approach to the problem was to relieve fully domestic property from the burden of rates.

Summary

10.19 The tax treatment of owner-occupied housing in Ireland is exceptionally favourable by international standards. There is

(i) no tax charge on the notional income that arises from the occupation of a house;

(ii) relief on interest allowable in respect of the borrower's only or main residence up to £2,400 for a single person and £4,800 for married persons jointly assessed;

(iii) relief on life assurance premiums, which may be used to fund house purchase, allowable at a rate of 50 per cent of the premiums paid up to a limit of £1,000 (maximum deduction £500). The limit is £2,000 for a married couple jointly assessed;

(iv) no capital gains tax charged on the gain accruing to an individual on the sale of his principal private residence and grounds of up to one acre;

(v) a stamp duty exemption for the purchase of grant-type new houses and a considerable measure of relief from the duty on the purchase of most non-grant type new houses;

(vi) a grant of £1,000 payable to all first-time buyers of new houses, which qualify for a Certificate of Reasonable Value issued by the Department of Environment;

(vii) a £3,000 mortgage interest subsidy generally payable over three years to all first-time purchasers of new houses.[7] A recipient of the subsidy can still claim the full interest relief for tax purposes. However, there is provision that the aggregate of the tax relief and the subsidy cannot exceed the amount of the annual loan repayment, and

(viii) an exemption from rates on domestic property since 1978.

10.20 It is proposed to give relief in 1983/84 to persons aged 65 years or

[7]Purchasers of second-hand houses who were on a local authority approved housing list are also entitled to the £3,000 mortgage interest subsidy.

over for rent paid in 1982 in respect of private tenancies up to a maximum of £1,000 rent.

Proposed Tax Treatment of Housing

10.21 To achieve equity between owners and renters of housing, it would be necessary either to charge the imputed rental income arising from housing to tax or allow a deduction in respect of rent paid. The high cost of giving a deduction for rent makes that option unattractive. It would further erode the tax base which already is too narrow and require higher marginal rates of tax. It would be inappropriate to give a tax deduction for local authority houses in either event, since these are already subsidised by the Exchequer. If it is desired to equalise the treatment of owners and renters of private accommodation, this should be done by restricting the tax advantages arising to owners rather than by extending them to renters. A likely effect of the latter course would be to increase rents in the same way as the existing tax concessions raise the price of owner-occupied accommodation. On these grounds, we oppose giving any deduction for rent paid. In principle, we accept that the most satisfactory method of removing the inequity between owners and renters is to charge to tax the excess of the notional income arising from the occupation of housing over any rent paid.

10.22 In principle, the imputed income from owner-occupied housing would be charged to tax in the following manner. An owner-occupier would have the net annual value of the house added to his taxable income and charged at his marginal rate. The net annual value could either be computed on the basis of the net annual rental value or by applying an appropriate interest rate to the capital value. The tax would be collected in the normal way under the machinery for collection of PAYE or Schedule D tax as appropriate. The private landlord would simply pay tax on any actual rent which he received after deducting expenditures on repairs and maintenance. The intermediate class of what may be described as the "tenant-owner" who paid a rent below the economic level because he was protected by the rent controls or had subsidised local authority accommodation or had acquired a partial interest in the house through leasehold arrangements, would be taxed on the excess of the full economic rent (as represented by the annual value of the house) over any rent which he was paying for it (exclusive of any element in the rent paid for the landlord's obligation to carry out repairs and maintenance). In these intermediate cases, the tenant would thus be treated as enjoying that part of the real income from the house which was not being paid to the landlord in rent.

10.23 The owner of the house would be allowed to set against his liability to tax on the annual value of the house the interest on any mortgage or other debt incurred for the purchase of the house. However, since the

annual value of the house would represent only the real value (excluding any inflationary capital appreciation), it would, in inflationary conditions, be proper to allow as a deduction from the annual value of the house only the real rate of interest on the mortgage debt.

10.24 The Department of Environment, which is responsible for housing policy, informed us that

> "the basic aim of the Government's housing policy is to ensure that, as far as the resources of the economy permit, every family can obtain a house of good standard, located in an acceptable environment, at a price or rent they can afford. A secondary aim is the encouragement of owner-occupation".[8]

The Department opposed the taxation of imputed income on the grounds that

(i) it would act as a disincentive to owner-occupation, and

(ii) it would be likely to be unacceptable to the general public because of the difficulty of appreciating the merits of a tax on imputed income.

10.25 We doubt that the taxation of imputed income would greatly discourage owner-occupation. This is shown clearly by the fact that in 1971 nearly 70 per cent of all houses were owner-occupied.[9] This was despite the fact that income tax under Schedule A was charged on owner-occupied houses until 1969 and rates were charged on domestic dwellings until 1978. The main effect of charging imputed income to tax would most likely be a reduction in the price of houses.[10] The taxation of imputed income on a realistic basis would also make possible a significant reduction in income tax rates. For example, on the basis of a total number of owner-occupied houses of 530,000 with an average capital value of £30,000 and a real rate of interest of 3 per cent, the total amount added to the income tax base would be £477 million. This could have produced about £150 million in tax or allowed a reduction of about one-eighth in income tax rates in 1981/82. This estimate takes no account of the 130,000 local authority houses which have been purchased by their owners.

10.26 Despite these considerations, it would be difficult to obtain general acceptance for the taxation of imputed income. There would also be significant difficulties in introducing such a scheme. A satisfactory valuation

[8] Letter of 16 February, 1981.

[9] The high rate of owner-occupation in Ireland may be partly explained by the relatively high proportion of the housing stock in rural areas, which tend to have high rates of owner-occupation.

[10] J. Copeland and B.M. Walsh, December 1975, *Economic Aspects of Local Authority Expenditure and Finance*, ESRI Paper No. 84 pp 87-90.

base would be essential. Even if undertaken immediately it is likely that a revaluation of house property would not be completed much before the end of this decade. Because of the difficulties of gaining public acceptance for the proposal and the inevitable delay before such a scheme could be introduced, we do not recommend that the imputed income from housing be taxed, except in the case of second houses.

10.27 We are concerned, however, that many of the present tax incentives for housing do not contribute effectively to the stated objectives of housing policy. The tax and other advantages attached to owner-occupation have encouraged people to acquire their own houses and have resulted in a very high proportion of owner-occupied houses in Ireland by international standards. We consider that owner-occupation is a desirable social goal which should be encouraged by the provision of incentives. However, the present extremely generous treatment of housing for tax purposes has resulted in an undue proportion of investment in certain types of housing to the detriment of more productive uses. Demand in many cases has been increased above real needs which has bid up the price of existing houses making it more difficult for first-time buyers to acquire their own homes. It has also led to over-investment and trading-up in house property and a waste of scarce resources since the cost of holding on to accommodation in excess of needs is nil.

10.28 We consider that any aid to encourage owner-occupation should be made more selective and concentrated on first-time home buyers. We make recommendations in line with this general policy in Chapter 11. These include the abolition of the general deduction in respect of mortgage interest and its replacement by a scheme which would confine interest relief to the first five years of home ownership.

EXEMPT INCOME

10.29 We now examine certain items of exempt income which might be charged to tax.

Short-term Social Welfare Benefits

10.30 Social welfare benefits are not statutorily exempt from tax. The Revenue Commissioners have advised that, in the absence of specific charging provisions providing for a charge to tax in respect of short-term benefits, they could not treat such benefits as income since they were not annual payments. This provides but one example of the need for a general definition of income with specific exclusions rather than the existing approach of listing items of income and excluding the items not listed.

10.31 The benefits not charged to income tax are the short-term benefits for unemployment, disability and occupational injury. Maternity allowance, intermittent unemployment (wet-time) insurance, deserted wife's benefit, invalidity pension and death grant are also excluded.

10.32 We received submissions that the present level of social welfare benefits constitutes a disincentive to work in that many employees can receive more in take-home pay from disability benefits than they obtain in wages net of tax and social insurance contributions when working. To the extent that this problem exists, it is aggravated by the arrangements providing for refunds of tax during periods of unemployment under the PAYE system. Under PAYE, for example, weekly-paid employees receive one fifty-second of their tax allowances each week to be set against their earnings for the week. In a week in which an employee is in receipt of unemployment or disability benefit, his earnings for tax purposes are regarded as nil and he is entitled to a refund of tax equivalent to the tax at the appropriate rate on the amount of his tax-free allowances for the week. These refunds, which are normally made at four-weekly intervals, are continued either until the end of the tax year or until the amount of tax repaid equals the amount of tax deducted in the earlier part of the year. The refunds may be quite substantial. For example, a married man with no children on average industrial earnings could have qualified for a minimum weekly repayment of almost £23 at 1981/82 rates of tax.

10.33 In an attempt to limit any disincentive effects arising from the payment of unemployment benefit, a scheme was introduced on 21 June, 1976 to limit the maximum after-tax income of an unemployed person to 85 per cent of the after-tax income he enjoyed in the period immediately prior to unemployment. This scheme applies only to recipients of unemployment benefit who are wholly unemployed. It does not apply to those in receipt of disability benefit, systematic short-time workers or recipients of flat-rate unemployment benefit.

10.34 The effect of the scheme is to limit the amount of unemployment benefit and any income tax refund which may be due to 85 per cent of the claimants' average net weekly earnings prior to unemployment or £170, whichever is the lesser. Average net weekly earnings consist of gross earnings from the beginning of the income tax year up to the date of claim, less income tax and the employee's portion of pay-related social insurance contributions paid, divided by the number of weeks in the period.

10.35 We raised the question of the administrative complexity of this scheme with both the Department of Social Welfare and the Revenue Commissioners. The Revenue Commissioners replied that the scheme is

"administered by the Department of Social Welfare and has little impact on tax offices. Indeed were it not for the fact that tax refunds are taken into account in measuring the benefits to be compared with the 85 per cent limit, the scheme would not involve any additional work for Revenue".

10.36 The Department of Social Welfare advised us that

"the imposition of the 85 per cent limit introduced a further element of complexity into the unemployment benefit scheme which necessitated additional staff at local offices to operate the system. However, it is now fairly well established and the system is working reasonably satisfactorily. There are delays (in a minority of cases) in finalising the pay-related benefit position in cases where the basic information cannot readily be supplied".

10.37 Table 14 shows the effect on take-home pay of incapacity for work in the latter half of the tax year. Where the figure in the last line of the table exceeds 100, the individual would have higher disposable income when incapacitated than he would receive if working. It is clear that, where this situation arises, tax refunds are a major contributory factor.

TABLE 14

Effect of Tax Rebate on Income of Representative Households While Absent from Work in Tax Year 1981/82

Income	Single person		Married man no children		Married man 4 children	
	£5,000 p.a. £96.15 p.w.	£6,000 p.a. £115.38 p.w.	£5,000 p.a. £96.15 p.w.	£6,000 p.a. £115.38 p.w.	£5,000 p.a. £96.15 p.w.	£6,000 p.a. £115.38 p.w.
Number of weeks employed in year before incurring tax liability = x	21	18	36	30	38	37
Average tax refund if incapacitated for remaining (52-x) weeks (£)	13.68	14.25	24.22	23.86	18.14	30.20
Average net income per week if incapacitated for (52-x) weeks (£)	71.84	80.10	98.78	106.11	117.20	136.95
Average net income per week if incapacitated during last (52-x) weeks of year as percentage of net income if employed (%).	75	69	103	92	122	119

10.38 We believe that the exemption of short-term social welfare benefits from income tax is contrary to equity principles which dictate that the amount of the income rather than its source should determine the amount of tax that is payable. The argument about the exclusion of such benefits constituting a disincentive to work is irrelevant. We recommend that those on social welfare benefits which are at present not charged to tax be brought within the tax net. In these circumstances, the scheme to limit the income of an unemployed person to 85 per cent of the after-tax income he enjoyed in the period prior to unemployment would no longer be necessary.

10.39 We discussed the administrative implications of taxing short-term benefits with the Revenue Commissioners who explained that the ideal course would be for the Department of Social Welfare to operate PAYE on such payments. However, this would give rise to great difficulties particularly in relation to unemployment benefit which would be regarded as a commencement and cessation under the PAYE regulations. An alternative would be for the Revenue Commissioners to collect the tax by direct assessment but this would result in a delay of over two years between the payment of benefit and payment of tax. This would be unacceptable both for the taxpayer and the Revenue Commissioners. We believe that the only realistic course is to operate some form of provisional deduction to the social welfare benefit at the time of payment which would, as nearly as may be, satisfy the liability. Adjustments could be made on review.

10.40 We have noted the intention of the United Kingdom Government to charge unemployment benefit to tax. This is being done in two stages by withholding tax refunds while benefit is being paid to a claimant. The withholding of refunds started from 6 April, 1982 but benefit paid before 5 July, 1982 will not be charged to tax.

10.41 In conclusion, we do not believe that the administrative difficulty of charging short-term social welfare benefits to tax is such as to warrant their continued exemption.

Compensation Payments for Loss of Office

10.42 Payments in compensation for loss of office cover payments made to a person, whether in pursuance of a legal obligation or not, by way of damages

(i) by reason of his ceasing to hold an office,

(ii) whatever the circumstances in which the termination has come about even if they amount to no more than his voluntary resignation, or

(iii) if the payments are in any sense a compensation to him for losing the profits of the office.

10.43 The payment on cessation of employment of a sum specified in a service contract is subject to taxation in the normal way under Schedule E. Where the service contract makes no provision for such payments, any payment made relating to the termination of the contract before its expiry date is subject to special tax rules covering payments on retirement or removal from employment. The special rules which apply with effect from 6 April, 1980 are as follows:

(i) The first £6,000 of compensation is tax free.

(ii) The basic exemption may be increased to an amount equal to the Standard Capital Superannuation Benefit which is calculated by the formula

$$\frac{A \times B - C}{20} \text{ where}$$

A = One year's average of the remuneration for the last three years of service;
B = Number of complete years of service, and
C = Any tax-free lump sum received or receivable under an approved superannuation scheme.

(iii) The basic exemption of £6,000 may be increased to a maximum figure of £10,000 if the following conditions are met:

(a) the claimant has never previously made a claim for a reduction or elimination of tax liability arising out of the receipt of a lump sum payment taxable under the provisions relating to such payments, and

(b) any tax-free lump sum benefit received or receivable under an approved superannuation scheme relating to the employment does not exceed £4,000. Where an amount of less than £4,000 is received or receivable the basic exemption is £10,000 less that amount.

(iv) The taxable amount of the lump sum is further reduced where the service in respect of the office or employment includes foreign service. The amount of the reduction is the portion of the taxable sum which bears the same proportion to the amount of that sum as the foreign service under the office or employment bears to the total service.

(v) Where the payment exceeds the exemption limit the tax payable is the lower of the following amounts:

(a) income tax calculated on the basis of treating the excess of the lump sum over the exemption limit as extra income earned in

the year of assessment in which retirement or removal from office occurs, or

(b) income tax calculated on the basis of taxing the lump sum payment (after deducting the exempt amount) at a rate obtained by dividing the total tax payable for the five years of assessment immediately prior to the year of retirement or removal from office by the taxable income of these five years. This is a form of averaging to mitigate the effect of charging the lump sum payment to progressive rates of tax in one year.

10.44 We believe that compensation payments for loss of office contribute to potential spending power in the same way as other receipts and should be charged to tax in full. We deal with the taxation of this and other lump-sum payments during the transition to a single rate of income tax in paragraph 38.9.

Lump Sum Retirement Benefits

10.45 Certain taxation benefits are provided for superannuation schemes which are approved by the Revenue Commissioners. The main rules with which approved schemes must conform are that the pension may be accumulated at the rate of one-sixtieth of final salary for each year of service and that roughly one-quarter of the value of the benefits may be commuted into a tax-free lump sum. No taxation benefits are provided for unapproved schemes.

10.46 The Committee on the Taxation Treatment of Provisions for Retirement which reported in the United Kingdom in 1954, was unable

> "to find any satisfactory explanation why this lump sum ever came to be treated as non-taxable. If we were dealing with the matter without any reference to existing practice we should have found it very difficult to recommend that any part of the benefit should be in tax-free form".[11]

10.47 Under the present income tax system, contributions to approved superannuation schemes receive preferential treatment to other savings in that they are allowed as a deduction from income for tax purposes. This favourable treatment is even more marked in the case of lump sums in commutation of pension which would attract tax liability if they were paid in the form of pensions. In principle, there is no justification for the continued exemption of lump sum retirement benefits from taxation as these confer the same spending power as other receipts.

---

[11] Cmd. 9063 paragraph 160.

10.48 It may be argued that to terminate this privilege suddenly would be unfair because expectations have been raised by existing practice. We do not consider that this is a valid reason for continuing to discriminate in favour of those who may qualify for such benefits. In many cases, these persons are substantially better off than those who do not qualify for superannuation benefits. We recommend that lump sum retirement benefits be charged to income tax.

Payments under the Redundancy Payments Act

10.49 Lump sum payments made to persons under the Redundancy Payments Act, 1967 are exempted from tax regardless of amount. Such payments do not reduce the amount of the exemption limit which applies to compensation payments for loss of office. These receipts come within the scope of our concept of income. Accordingly, we recommend that they be charged to income tax.

Compensation Payments for Physical or Other Injury

10.50 Compensation paid in a lump sum for personal injury is not charged to income tax. Such compensation may be made up of a number of elements. These may include income already lost as a result of the injury, reduced capacity to earn income in the future and compensation for pain and suffering. The first two elements would normally be regarded as income. The third would not.[12]

10.51 So long as compensation received in a lump sum for personal injury is not chargeable to tax, the amount of compensation given by the Courts in personal injury cases will continue to be calculated on the basis that what has been lost as a result of the impairment of the ability to earn is the discounted present value of what would have been earned, less tax on that amount.[13] It could be argued that this practice provides a benefit to the person who caused the injury at the expense of all other taxpayers who must make up the loss to the revenue. Therefore, the total exemption of compensation payments does not benefit the recipients of the compensation but merely provides a hidden subsidy to insurance premiums.

10.52 In principle, we consider that the part of any compensation payment which is attributable to loss of income, whether in the future or in the past, should be charged to income tax. To achieve this, it may be necessary for the Revenue Commissioners to draw up general rules to apportion compensation payments into their taxable and non-taxable elements.

[12]See paragraphs 10.86 to 10.89 for the treatment of human capital.
[13]*British Transport Commission v Gourley (1956) AC 185.*

Foreign Pensions

10.53 Section 9 of the Finance (Miscellaneous Provisions) Act, 1968 exempts from tax foreign pensions paid to Irish residents which either correspond to Irish social welfare pensions or would be exempt from tax if the recipient was resident in the country of origin. The purpose of the exemption was to induce foreigners, mainly residents of the United States, who were in receipt of tax-free social security and other pensions to take up residence in Ireland.

10.54 This exemption generates pressure to exempt Irish pensions from income tax. The repeal of the exemption would not give rise to any administrative difficulty. Since these pensions come within our definition of the tax base, we recommend that they be charged to income tax.

Artists' Exemption

10.55 Certain earnings of individuals resident in Ireland, who are determined by the Revenue Commissioners to have produced a work or works generally recognised as having cultural or artistic merit, are exempted from income tax. A work is defined as an original and creative work, whether written, composed or executed, which falls into one of the following categories:

(i) a book or other writing,
(ii) a play,
(iii) a musical composition,
(iv) a painting or other picture, or
(v) a sculpture.

10.56 The relief was introduced to provide

> "encouragement to the creative artists in our midst and to help create a sympathetic environment here in which the arts can flourish".[14]

10.57 The most recent information in relation to the number of determinations made under the scheme is as follows:

Books and other writings	584
Plays	140
Musical compositions	60
Paintings and other like pictures	268
Sculptures	70
Total	1,122

[14]Dáil Debates, Official Report, Vol. 240, Col. 671.

10.58 One of the problems with the relief is that it encourages artists with very high earnings to move to Ireland on a temporary basis only. Since these earnings are tax-free, they accumulate capital faster than they otherwise would. Once a sufficient amount of capital has been accumulated, there may be a tendency for such artists to move. The relief also gives rise to claims for its extension to artistic performers and innovators in non-artistic fields.

10.59 The existence of this relief is contrary to equity principles which require that individuals with the same incomes pay the same amount of tax if they are in similar circumstances which are relevant. If it is desired to encourage artistic activity, we believe that this would be more effectively achieved by repealing the exemption and increasing the direct financial allocation to the arts. Such a change would also improve the equity of the tax system. The adoption of the single rate of tax will be of great benefit to artists and others whose income may fluctuate. We recommend the repeal of artists' exemption.

Payments under the Aosdana Scheme

10.60 Early in 1981, the Arts Council established Aosdana as an affiliation of artists engaged in literature, music and visual arts. It is envisaged that members of Aosdana resident in Ireland will be eligible to receive an annuity for a term of five years to assist them to concentrate their time and energies in the full-time pursuit of their arts. The annuity will be valued initially at £4,000. We recommend that such annuities be charged to income tax.

Casual Gambling Winnings

10.61 At present, all gambling and lottery winnings are not liable to income tax unless they fall to be taken into account as receipts of a trade, profession or vocation, such as in the case of a bookmaker or casino promoter. We recommend that gambling winnings in excess of a *de minimis* figure should be chargeable to income tax. We would propose to include such items as Prize Bond Prizes and Sweepstake winnings.

10.62 The taxation of gambling winnings raises the question of the deductions to be allowed. In the United States, losses may be set against winnings but not against other income. We recommend that all gambling losses should only be available to be set-off against future winnings from gambling.

10.63 In making these recommendations, we have taken account of the following evidence from the Revenue Commissioners:

> "In favour of taxing (gambling) winnings, it could be said that for the future it would deprive the tax evader of the explanation he now so frequently offers for otherwise unexplained accretions of wealth that are thought by the Revenue to represent accumulated, and unreturned profits, and to that extent it would stop up a hole in the Revenue net. It would also enable the Revenue to obtain tax on bookmakers' winnings on private bets. Bookmakers are in a favourable position to make money in this way and the argument that such profits are incidental to the trade or are gained in the process of laying-off is pushed by the Revenue as far as possible but without conspicuous success".[15]

Exemption of Sweepstake and Lottery Profits

10.64 The taxation of gambling winnings raises the issue of the exemption of the profits derived from running sweepstakes and lotteries. Section 346 of the Income Tax Act, 1967 exempts from tax the profits of any sweepstake held under the Public Hospitals Act, 1933. We recommend that this exemption be withdrawn.

10.65 Section 350 exempts from tax profits from a lottery to which a licence under Part IV of the Gaming and Lotteries Act, 1956 applies. Section 27 of that Act specifies that before a licence is issued the lottery shall comply with the following conditions:

(i) The permit-holder shall derive no personal profit from the lottery;

(ii) The total value of the prizes shall not be more than £300, and

(iii) The value of each prize shall be stated on every ticket or coupon.

We recommend that this exemption be continued on *de minimis* grounds.

DEDUCTIONS FROM INCOME

10.66 We now examine some of the deductions and reliefs which are available, at present, for income tax purposes. In this section we also consider the introduction of new reliefs which were put forward in submissions.

Provision for Ill-health

10.67 Under existing legislation, income tax relief is given to individuals in respect of

(i) medical insurance premiums paid by them to an authorised insurer, normally the Voluntary Health Insurance Board;

(ii) medical expenses incurred in respect of the provision of health care under the headings practitioners' fees, maintenance or treatment in

[15] Letter of 26 November, 1980.

hospital, drugs and medicines, certain medical appliances, physiotherapy, nursing and the cost of transport by ambulance, and

(iii) premiums paid under a permanent health insurance policy approved by the Revenue Commissioners.

Medical Insurance Premiums

10.68 Relief is allowed for income tax purposes in respect of medical insurance premiums paid in the year preceding the year of assessment. This was introduced in 1955 to encourage the development of the Voluntary Health Insurance Board which had just been established. While the Voluntary Health Insurance Board is the main body carrying on medical insurance, licences under the Voluntary Health Insurance Act, 1957 have been issued to a number of other bodies. Premiums payable to these bodies also qualify for relief.

10.69 Since the relief was introduced, the provision of public health services has been extended. In particular, hospital care in a public ward is now provided free of charge to all persons at the point of use. Heavy expenditure on drugs in the case of long-term illnesses is also reimbursed by health boards. Furthermore, the Voluntary Health Insurance Scheme has become well-established and widely used. Quite apart from the question of tax relief the value of such insurance is now appreciated widely. Accordingly, we recommend that the relief should now be abolished.

Health Expenses

10.70 Since 1967, income tax relief has been available in respect of certain unreimbursed medical expenses. The relief is now given in respect of expenses which exceed £50 in a year per individual or, if more beneficial to the taxpayer, £100 per family. Only expenses arising from the provision of non-routine health care are allowable. Expenses relating to routine maternity care or routine ophthalmic or dental treatment are excluded from relief.

10.71 We understand that the cost of this relief is very small because most taxpayers are fully covered either under the Health Acts or through participation in the VHI scheme. Claims for the relief arise mainly from geriatric cases ineligible for care in public hospitals and long-term illness cases unable to obtain adequate insurance cover. We consider that the most appropriate method of helping persons in these categories is through direct expenditure under the health services. Until adequate provision can be made in this way, we recommend that health expenses relief be retained for persons who incur substantial expenses in the treatment of long-term or recurrent illness.

In such cases, we recommend that the excess of unreimbursed expenses over £500 per year be allowed.

Permanent Health Insurance Schemes

10.72 Permanent health benefit schemes are schemes approved by the Revenue Commissioners which provide for regular payments to an individual in the event of loss or diminution of income as a result of ill-health. Prior to 1979, contributions to these schemes were not deductible for tax purposes. Benefits were not charged to tax unless they were payable for a period of twelve months or more. Following the granting of relief for contributions, all benefits are now liable for tax. The amount on which relief is granted cannot exceed 10 per cent of the total income for the year of assessment.

10.73 We consider that these schemes are a form of insurance akin to motor, travel or fire insurance and that they should be treated for tax purposes in the same way. We recommend that the deduction for premiums paid under permanent health insurance schemes should be withdrawn and any benefits paid under these policies be free of tax.

Relief for Expenditure on Residential Premises

10.74 A special relief was introduced on a pilot basis for 1979/80 for a person who incurred expenditure in respect of the maintenance, repair, improvement or insulation of his residence (including gardens). The relief is granted on the labour element of the cost in excess of £50, provided that the work was carried out by a registered person. The maximum deduction was £450. The relief was extended for a further year in both 1980 and 1981. The maximum deduction was increased to £900 for a married couple who are assessed jointly. The Finance Bill, 1982 proposes that the relief be continued for a further year.

10.75 A deduction in respect of expenditure on repairs and maintenance of housing would be appropriate if the taxation of the imputed gross income from the occupation of housing were introduced. We have recommended that this imputed income should not generally be brought into charge because of the administrative difficulties of doing so. Accordingly, an allowance for maintenance expenditure is not appropriate. On this basis, we recommend that the relief for expenditure on residential premises be terminated.

10.76 We note that following the Murphy Case, the monetary limits applying to certain reliefs were doubled automatically for married couples jointly assessed. We believe that, in certain cases, this was inappropriate. In particular, equity might have been better served by tying particular reliefs,

such as the relief for expenditure on residential premises, to a particular residence. This would have avoided the need to give double relief to married couples.

Schedule E Expenses

10.77 Schedule E is the schedule under which employed persons are taxed and, generally speaking, any tax arising under this schedule is collected through the PAYE system. The rule governing the allowance of expenses under Schedule E which was first enacted in 1853 is as follows:

> "If the holder of an office or employment of profit is necessarily obliged to incur and defray out of the employment thereof the expenses of travelling in the performance of the duties of the office or employment, or keeping and maintaining a horse to enable him to perform the same, or otherwise to expend money wholly, exclusively, and necessarily in the performance of the said duties, there may be deducted from the emoluments to be assessed the expenses so necessarily incurred and defrayed".[16]

The rule in effect allows a deduction of expenditure incurred wholly, exclusively and necessarily in the performance of the duties of an office or employment and of that expenditure only.

10.78 Submissions have been received that the rule is too narrow and is unfair compared with the more liberal expenses allowable in the case of self-employed persons. We deal with this issue in Chapter 31. At this stage, we consider whether any alterations are necessary, of themselves, in the Schedule E rule.

Relaxation of Schedule E Expenses

10.79 It is doubtful if the present inequity could be satisfactorily dealt with by bringing the expenses rule under Schedule E into line with that of Schedule D. Once expenses, voluntarily undertaken by an employee in connection with his duties, are allowed as deduction from his income, it becomes very difficult to draw a clear line of distinction between such expenses and personal expenses or between expenses reasonably incurred and those not reasonably incurred. If the Schedule E expenses rule were relaxed, the result would be to open up new avenues of tax avoidance and to give rise to inequities between one Schedule E taxpayer and another whereas the present rule achieves a high degree of equity among Schedule E taxpayers. For that reason only, we recommend no general change in the Schedule E expenses rule.

---

[16] *Income Tax Act, 1967*, Schedule 2, Rule 3.

Expenses Incurred in Travelling to and from Work

10.80 Submissions have argued that a deduction should be allowed for the cost of travelling between home and place of employment. One submission stated that

> "The (Schedule E expenses) rule was framed at a time when a man lived near his work. This situation is utterly changed today as there are very few people who live within walking distance of their work — they have to rely on transport of one kind or another. It is, therefore, suggested that some allowance ought to be given, based perhaps on the cost of public transport, to cover the expense of one return journey per day for the employed person. Such an allowance is found in various tax codes — for instance, an expense of this nature is allowed in Belgium, Netherlands, West Germany, Austria and Switzerland".

10.81 In relation to travelling expenses, there is little difference in practice between the Schedule D and Schedule E expenses rules, since travel between home and place of business would not normally be allowed for tax purposes under Schedule D. Travelling expenses incurred during the course of an employment and not reimbursed by the employer are allowed under Schedule E.

10.82 In denying a deduction in respect of the costs of travelling to and from work, the present law treats them as a form of consumption. It could be argued that they should be allowed, since they are a prerequisite to the earning of income. However, the same could be said of expenditure on basic food, clothing and shelter. The case for giving a deduction in this area rests on the basis that the incidence of such expenditure, unlike that on basic necessities, varies considerably between individuals in a way that cannot be explained wholly by personal preference. A taxpayer may face relatively high costs of travel because he lives a considerable distance from his place of work or he may be forced to use a car for lack of public transport facilities. Such taxpayers may not be in a position to change their housing.

10.83 If a general deduction in respect of expenses incurred in travelling to and from work were allowed, there would have to be controls on the amount deductible in order to deny deductions in respect of extravagant expenditure. One possibility would be to limit the deduction to the expenses that would be incurred if public transport were used. Expenses of other modes of travel could be allowed where public transport was not available. This would give rise to disputes between taxpayers and the Revenue Commissioners about the availability of public transport.

10.84 The administrative costs and difficulty of introducing such a concession would be considerable. The Revenue Commissioners have informed us that some 750,000 claims would be lodged annually and would have to be scrutinised individually to establish the mileage covered, the mode of transport used and cost incurred. It is not clear that the allowance would result in a significant increase in equity. An allowance for transport costs in travelling to work could encourage people to live further away from their place of employment. In current circumstances, in which there is concern about the efficient use of energy, market forces which operate to encourage people to live as near as possible to their place of employment should be allowed to work unhindered. We recommend that no change should be made to extend tax relief in respect of expenses incurred in travelling to and from work.

Relief in Respect of Educational Expenses

10.85 The cost of acquiring qualifications and keeping up with new developments is not allowed to employees for tax purposes. By contrast, an employer who incurs expenditure in training his staff is allowed to deduct the expenses in computing business profits. It was submitted that

> "the cost of obtaining additional qualifications, undertaking courses of study and subscribing to professional associations, institutes and similar societies should be allowed without question where they are incurred by employed persons".

10.86 The health, strength, knowledge and skills of individuals can be included in the term human capital. Expenditures on education and training may be considered as an investment in human capital which increase earnings in later life. These earnings will be taxed although they constitute net income only to the extent that they exceed the capital cost. It could be argued that human capital should be treated like other productive assets for tax purposes. Under such an approach, the returns from employment would be reduced by the expenses of maintaining the worker and depreciation would be allowed on the worker's health, strength and knowledge in order to arrive at the taxable net return. We believe that such an approach is not appropriate for tax purposes. The whole raising of a human being inevitably involves costs. These costs usually are borne by his parents and society as a whole and are not borne by the individual claiming the deduction as they are when physical assets are acquired.

10.87 Claims for allowances for human capital would have to be confined to expenditures which were incurred solely with a view to increasing the earning capacity of the individual. Administratively, it would be very difficult, if not impossible, to devise a scheme that would be confined effectively to expenditures of this kind. Professional training is not

necessarily distinct from general education and, even in the case of outlays on specialised training and education, it would be impossible to establish whether the outlays served solely economic purposes or whether they included an element of personal expenditure.

10.88 The State already provides substantial financial support for education and training. We consider that this is a more appropriate method of providing State aid towards the acquisition of general skills. On this basis, we do not recommend the introduction of relief for educational expenses.

10.89 Employers will be willing to finance the acquisition of skills which are of specific value in the course of employment. This may be in the form of in-house training or external courses. If they do so, a deduction will be given in computing the profits of this business. We consider that no further deduction is justified in respect of educational and training expenses.

Schedule E Employee Allowance

10.90 A special allowance of £400 was introduced in 1980 for each PAYE taxpayer. This was increased to £600 in 1981. The purpose of the allowance was to

> "improve the tax progression for these (PAYE) taxpayers and also to take account of the fact that the self-employed generally have at present the advantage of paying tax on a previous year basis".[1]

10.91 This allowance has a number of unsatisfactory features. Firstly, married couples with two incomes subject to PAYE obtain twice the allowance of a couple with the same amount of PAYE income from one source. Secondly, the amount of the allowance is not related to income and therefore does not take account in a satisfactory way of the relative disadvantage of being charged under Schedule E. Thirdly, Schedule E taxpayers in a position to control their own remuneration or that of their spouses or children, for example directors of proprietary companies, were excluded from qualifying for the allowance even though they may pay tax on a current year basis. This exclusion appears to us to be unfair.

10.92 We consider that the proposals in Chapter 31 with regard to the basis of assessment for Schedule D will substantially remove the advantage from being charged to tax under Schedule D rather than Schedule E. Accordingly, we recommend that the additional allowance for Schedule E taxpayers should be abolished, when the bases of assessment are brought into line.

---

[1] Dáil Debates, Official Report, Vol. 318, Col. 73.

Interest on PAYE Tax

10.93 Strictly speaking, the interest provisions which we recommend in Chapter 31 in the case of tax charged by direct assessment should also apply to tax deducted under PAYE. However, this would be impossible to operate until after the end of the year of assessment. We recommend that interest on underpayments and overpayments of PAYE tax should run from the end of the year of assessment for which the tax was underpaid or overpaid.

Annual Payments

10.94 Income tax was constructed originally on the principle that annual payments should be treated for tax purposes as the income of the recipient and not the income of the payer. According to the original conception, any annual payment, whether payable by virtue of a charge on the property of the payer or merely as an obligation by virtue of a contract, was to be treated as income of the recipient and not of the payer.

10.95 There has never been a precise definition of annual payment but the term has been the subject of judicial interpretation on a number of occasions. A payment under convenant voluntarily undertaken has been treated as an annual payment because the law has regarded a promise made under the seal of a promiser as a binding obligation even if voluntarily undertaken without value received in exchange, whereas promises not so secured have been treated as not binding.

10.96 So long as income tax remained essentially a flat-rate tax it was a matter of comparative indifference to the Exchequer whether the burden of the tax on the annual payment fell upon the payer or the recipient. What mattered was that it was not to be taxed twice. However, when the tax became progressive it became important to determine whether this form of income was the income of the payer or the recipient, if their respective marginal rates of tax differed substantially. Accordingly, since 1922, various statutory conditions have been laid down with which convenants must comply if they are to be accorded recognition for tax purposes.

10.97 In 1922, it was provided that for income tax purposes any settlement under revocable dispositions, dispositions which could not exceed six years and dispositions by a parent in favour of a child of his for less than the life of the child, should be treated as income of the disponer. The Finance Act, 1940 greatly reduced the scope for avoiding personal income tax by means of convenants. It provided that any income which under a disposition "is payable to or applicable for the benefit of any other person" is deemed to remain the income of the disponer unless

(i) it arises from capital of which the disponer has absolutely divested himself in favour of the other person, or

(ii) is payable to an individual for his own use for a period which may exceed six years, or

(iii) is applicable for the benefit of a named individual for a period which may exceed six years.

10.98 Since 1940, a number of exceptions have been made to the general rule that covenants in favour of charitable institutions are not recognised for tax purposes. It was provided in 1957 that payments made under a disposition in favour of a university or college in the State to enable it to carry on research would, if payable for a period of three years or longer, be deductible for tax purposes. This provision was extended in 1959 to grant similar relief for payments to universities, colleges or schools to assist them to teach the natural sciences. Finally, in 1973, similar treatment was introduced for payments made under deed in favour of any body of persons having consultative status with the United Nations or the Council of Europe and having as its sole or main object the promotion of human rights.

10.99 In a memorandum to us on the subject, the Department of Finance and the Revenue Commissioners indicated the growth in the use of covenants as follows:

> "In recent years a practice has developed whereby a member of a religious community in receipt of a salary as a teacher has, by means of a covenant to assist his school in the teaching of natural sciences, been able to alienate all his taxable income . . . The legislation is also being availed of by parents who can disguise part of the fees they pay to schools for the education of their children as covenanted payments for the teaching of the natural sciences".

10.100 As regards deeds of covenant in favour of schools, colleges and universities for the purposes of carrying on research or teaching the natural sciences, we believe that our general approach to the question of tax expenditures applies. Equity and efficiency would be improved if such covenants were not recognised for tax purposes. However, covenants have become widely used. If they were suddenly not to be recognised for tax purposes, hardship might result in a number of cases. Therefore, we recommend that the recognition of new covenants for tax purposes should be withdrawn from a current date. Existing covenants could be allowed to run their course.

10.101 We recognise that there is a different view to the one which we have adopted. This is that private charity should be encouraged by means

of tax incentives. We consider that the view we have taken is the correct one in principle, but we will return to this issue in our report on the question of incentives.

10.102 Difficulties have also arisen in practice in relation to the 5 per cent limitation on income covenanted in favour of children over 21 years of age or grandchildren. The payer is obliged to deduct tax from the portion of the payment under covenant which is recognised for tax purposes. However, at the time of payment, the total income for the year of assessment involved will not have been determined. As a result, the 5 per cent limit cannot be quantified so that provisional payments only are possible.

10.103 We consider that the administration of the tax code could be simplified without loss of equity if income covenanted in favour of children or grandchildren were treated as applications of income. For this reason, we recommend that the recognition of new covenants for tax purposes should cease.

Covenants between Separated Spouses

10.104 Payments under deed have also been used extensively by separated spouses. The payment of maintenance under a covenant enables the spouse paying the maintenance to obtain tax relief on the payment. On the other hand, no tax relief is granted on maintenance payments made under a court order. This is because the Courts fix a sum for maintenance on the basis that it will be free of tax. Depending on the degree of co-operation between the spouses it would be open to the taxpayer to follow the court order and have the maintenance payments treated as applications of income or enter into a deed of separation and have the maintenance payments treated as alienations of income and hence deductible for tax.

10.105 The enactment of the Family Law (Maintenance of Spouses and Children) Act, 1976 has complicated this question. Under the Act, either party can, after a settlement has been reached, go before the Courts and request that the terms of the settlement be made an Order of Court. This means that there is considerable risk in a taxpayer agreeing to maintenance payments on the assumption that these are going to be annual payments deductible for tax purposes.

10.106 One possible course of action would be to provide that all maintenance payments to a separated spouse, whether under a court order or a deed of separation, would be regarded as annual payments for tax purposes. This would reverse the line taken in the 1976 legislation which was based on the findings of the Committee on Court Practice and Procedure. It would cause difficulties in that a total review of all cases fixed by the Courts would be required in order to establish a new level of maintenance payments to take account of the tax liability attaching to these payments.

10.107 In all the circumstances the best approach seems to us to provide that all new covenants be disregarded for tax purposes. This would avoid the problems which arise where covenanted payments are converted into net payments when they are confirmed by court order. It would also align the tax treatment of arrangements made under a court order with other arrangements. Where such payments are being made the spouse making the payments should qualify for the married person's tax credit.

Recommendations

10.108 We make the following recommendations for change with regard to the income tax base:

1. Due to the administrative difficulties of charging the imputed rental income from housing and other durable goods, such income should continue to be exempt from tax, except in the case of houses other than a taxpayer's principal private residence.
2. Rent should not be allowed as a deduction for income tax purposes.
3. All social welfare benefits should be charged to income tax.
4. The scheme to limit the income of an unemployed person to 85 per cent of the after-tax income enjoyed in the period prior to unemployment could be terminated if all social welfare benefits were taxed.
5. Compensation payments for loss of office should be charged to income tax in full.
6. Lump sum retirement benefits should be charged to income tax in full.
7. Lump sum payments under the Redundancy Payments Act, 1967 should be charged to income tax in full.
8. That part of compensation payments for physical or other injury which is attributable to loss of past or potential future income should be charged to income tax.
9. The exemption of certain foreign pensions paid to Irish residents under section 9 of the Finance (Miscellaneous Provisions) Act, 1968 should be repealed.
10. The exemption of the earnings of certain artists should be terminated.
11. Payments to artists under the Aosdana scheme should be charged to income tax.
12. Gambling winnings in excess of a *de minimis* figure should be charged to income tax.

13. Gambling losses should only be available for set-off against future winnings from gambling.

14. The exemption from tax of the profits of sweepstakes held under the Public Hospitals Act, 1933 should be withdrawn.

15. Medical insurance relief should be abolished.

16. Until adequate provision can be made through direct expenditure under the health services for long-term illness, health expenses relief should be retained for unreimbursed expenses in excess of £500 per annum.

17. The deduction for premiums under permanent health insurance schemes should be withdrawn and any benefits under these policies paid free of tax.

18. Relief for expenditure on residential premises should be terminated.

19. No general change should be made in the Schedule E expenses rule.

20. No change should be made to extend tax relief in respect of expenses incurred in travelling to and from work.

21. No further relief should be introduced in respect of educational expenses.

22. The additional deduction for Schedule E taxpayers should be ended when Schedule D taxpayers are put on a current year basis of assessment.

23. Interest on underpayments and overpayments of PAYE tax should run from the end of the year of assessment for which the tax was underpaid or overpaid.

24. Recognition of new covenants for tax purposes should be withdrawn from a current date. Existing covenants could be allowed to run their course. In cases in which an individual is making payments under covenant to a separated spouse, such an individual should be entitled to the married person's tax credit.

CHAPTER 11

THE TAXATION OF BORROWING AND SAVING

Introduction

11.1 In this chapter we consider the personal income tax treatment of borrowing and saving. In Appendix 8 we review the economic background and data on savings in Ireland. We consider that the overall balance of the income tax system in Ireland is heavily weighted towards borrowing and against saving. This arises because, in determining income for income tax purposes, little or no account is taken of the effect of inflation on the underlying asset (in the case of saving) or liability (in the case of borrowing). We recommend that this be rectified. This would reduce the discrimination against saving in the income tax code. A further issue which arises is the differential treatment of saving in different forms for income tax purposes. We recommend that these be brought into line, except in the case of retirement savings through approved media. In addition to improving the equity of the tax system, we believe that these changes would lead to improvements in economic efficiency as the distortions which result from the present system were eliminated.

11.2 In Chapter 18 we recommend that the higher rates of income tax be replaced by a direct expenditure tax. This tax would exempt saving and charge dissaving. It would thus be an additional incentive to an improved balance between saving and consumption.

Effect of Income Tax Concessions on the Allocation of Saving

11.3 An efficient capital market equalises the rate of return at the margin to all forms of saving. Differences in the actual rate of return may continue to exist but these are attributable to differences in the degree of risk and the relative illiquidity of various assets. However, ignoring risk and other such considerations, savers will tend to put their resources into the uses which yield the greatest net returns.

11.4 To consider the effects of differential exemptions (or rates of taxation) on savings behaviour, a distinction must be made between the stock of savings and the flow of savings. The stock of savings is the existing pool

of resources comprising all past savings. This is vast compared with the flow of savings which represents the increase in the stock of savings in any given period. A tax subsidy on one form of saving would make that form of saving relatively attractive. The working of the capital market would result in a reallocation of resources up to the point where all rates of return are equalised, once more, at the margin. Once this happens, the tax concession is fully capitalised in the price of the asset and forms an integral part of the return to the form of saving which it is desired to encourage. There is some loss of economic efficiency corresponding to the resources which are put to less productive use. This loss persists for as long as the preferential tax treatment exists. When the adjustment to the existing stock of savings is completed, the tax subsidy has no effect on the flow of savings. These will be distributed according to the rates of return to be obtained on the market and will depend on the productive potential of alternative forms of investment. A lasting effect on the flow of savings requires not merely the introduction of tax subsidies but their continuous improvement. We conclude that differential tax subsidies on savings are economically inefficient but the inefficiency is confined to the allocation of existing resources and does not affect the efficient allocation of future savings.

11.5 The structure of income tax reliefs and exemptions in respect of savings has been built up over a number of years in pursuit of a variety of objectives and is now extremely complex. The justification for particular arrangements has to be considered in the light of the criteria of equity, efficiency and simplicity which we have adopted. In this context, efficiency may be taken to require fiscal neutrality. The closer this can be approached, the more efficient the allocation of resources is, in theory, likely to be. Neutrality is best seen as a benchmark from which departures need to be justified.

11.6 The present fiscal treatment of saving is incoherent. It is the result of a series of measures introduced over a long period of time designed to achieve particular effects which, cumulatively, have produced unintended anomalies and inconsistencies. The value of many reliefs has been wholly or partly capitalised into the value of the relevant assets.

Inflation and the Return from Savings

11.7 Savings may be held in a variety of forms such as cash, current and deposit accounts, fixed interest securities, ordinary shares or real assets. We now consider the implications of applying our concept of income to these types of assets.

11.8 At present, the real rate of return to saving is negative except for certain, very limited, State schemes. In this situation, a tax exemption on interest is not so much a tax subsidy on saving as a partial exemption from

the tax base of a real capital loss. It amounts to a partial offset against inflation and merely reduces the extent to which the real rate of return is negative. It cannot make the real rate of return positive.

11.9 In Chapter 13 we recommend that in respect of chargeable assets for capital gains tax purposes, a liability to capital gains tax should arise only on realisation of the asset after the value of the asset in terms of general purchasing power had been maintained. The annual returns from the asset would be taxed in full as they arise. Holders of such assets are protected from the effects of inflation for tax purposes by indexation of the capital asset.

11.10 Indexation of capital values is not suitable for liquid assets such as bank or building society deposits because it requires knowledge of the average balance of the deposit over a period of time. If changes are made very frequently, this becomes impossible for the Revenue Commissioners to monitor. An alternative is to base indexation on receipts of interest income which will measure the average balance over the period. Receipts of interest income are then multiplied by the nominal rate of interest minus the rate of inflation, all divided by the nominal rate of interest. This figure of "adjusted interest receipt" would be the figure for tax purposes.

11.11 For example, a taxpayer may be in receipt of £100 of money interest on a deposit account which has been calculated at the rate of 10 per cent. If the rate of inflation over the period is 20 per cent, then taxable income is defined as

$$\frac{£100\ 10-20}{10} = £100\ (-1.00) = -£100$$

that is, the taxpayer may deduct £100 from his taxable income. Since the rate of inflation is higher than the rate of interest, the taxpayer has in fact received a negative real rate of interest on his deposit.

11.12 The same inflation adjustment would be made for interest payments which were deductible for tax purposes. Only the real component of interest would be an allowable deduction. In recent years, when inflation rates were higher than interest rates, this would have meant that borrowers would have had a net addition to their taxable income instead of a net subtraction.

11.13 We asked the Revenue Commissioners for their views on the administrative implications of introducing indexation of interest. They replied that the main burden of identifying the real return on assets on which indexation of interest was applied would fall on financial institutions.

Once this was done, the Revenue Commissioners would be able to deal with it.

11.14 The question also arises whether or not the holders of money should be allowed to deduct from their income for tax purposes the fall in the real value of their money balances. The answer in principle must be yes. One argument for not extending indexation to money in various forms (e.g. current accounts) is that the imputed income from holding wealth in this form is not taxed. Examples of this imputed income are the benefits from liquidity and the services provided by banks at charges below the market cost of supplying those services. But this is not convincing because the value of these services to the investor is not necessarily related to the rate of inflation. Indexation could be denied, on administrative grounds, to money held in certain institutional forms, such as deposits on which no interest was paid and to coins and notes. Thus, real losses on cash would not be tax-deductible. This would provide an incentive for banks to pay interest on current accounts (to enable their customers to claim the benefit of indexation) and to charge for the services provided.

11.15 We recommend that the income from all interest-bearing deposits should be charged to tax to the extent only that the rate at which it accrues exceeds the rate of inflation during the period of accrual. In so far as the interest earned is insufficient to compensate for the erosion of the capital value of the deposit, the shortfall should be allowed as a deduction against other income. Interest on borrowings should only be allowed for tax purposes to the extent that the rate at which it is paid exceeds the rate of inflation. These are essential elements in our recommendations which involve a systematic adjustment of the tax base to allow for the erosion of capital by inflation. These elements include, in addition to indexation of interest, indexation for capital gains tax purposes and the adjustment of business income and they form an integrated package. In the interests of equity and efficiency all three elements must be implemented.

Loan Interest

11.16 Income tax relief for interest on money borrowed for non-business purposes is allowed up to a maximum deduction of £2,400 (£3,500 for widowed persons and £4,800 for married couples assessed on a joint basis). This relief applies where the interest in question is either "yearly interest" or interest on an advance from a bank, discount house or stockbroker.

11.17 The Finance Bill, 1982 includes proposals to change the reliefs for personal interest. The new provisions differentiate between loans taken out for the purchase, repair or improvement of a sole or main residence and other loans. Interest on loans in the former category will be eligible for relief irrespective of when they were taken out. In the case of other loans,

those taken out on or before 25 March, 1982 will attract the relief allowable under existing law up to 1984/85 after which they will be subject to a specified capital limit, while those taken out after 25 March, 1982 will be subject to this limit as from the dates they are taken out. The capital limits are £5,000 in the case of a married couple, £3,600 for a widowed person and £2,500 for a single person. In addition, interest, whether "yearly interest" or not, will continue to be allowed for tax purposes in the following cases:

(i) Interest laid out for the purposes of a trade or profession.

(ii) Interest allowable against rental income.

(iii) Interest on money borrowed to pay death duties.

(iv) Interest on money borrowed to acquire an interest in a company or partnership or in granting a loan to a company or partnership.

11.18 The question as to whether interest is "yearly interest" or not is of importance only in relation to non-business interest paid to lenders other than banks, discount houses or stockbrokers, for example, interest paid to a building society, credit union or life assurance company. The expression "yearly interest" is not defined in law. The tests which have been applied by the Courts to determine whether interest is yearly interest or not are that the loan, in respect of which the interest is payable

(i) must not be a short loan (a loan for a term which cannot continue for a period of twelve months or more);

(ii) must have a measure of permanence;

(iii) must have a future tract of time, and

(iv) must not be repayable on demand.

11.19 Interest on "bridging loans" where an individual sells his only or main residence and acquires another qualifies for additional relief. The bridging loan limits apply for a period of twelve months only.

11.20 In its submission the Central Bank of Ireland dealt with the question of the deductibility of interest for tax purposes in the following terms:

> "It is arguable, however, whether any interest on personal borrowings, with the exception of interest on borrowings to finance the acquisition of assets, should be an allowable expense for tax purposes. Tax concessions on such loan interest amount, in effect, to a subsidy on personal borrowings and tend to divert savings from the financing of investment. It is difficult to see the justification for such a subsidy, which is likely to lead to a misallocation of resources and a loss of

efficiency. A case can be made, however, for treating interest on loans to finance the acquisition of assets as an allowable expense for tax purposes. If the present practice is continued of not imputing an income on physical assets which do not yield a monetary return, the relief should be confined to cases where the asset yields (or is capable of yielding) a taxable monetary return. If, however, a comprehensive concept of income were to be adopted, then the relief could be extended to cases where the borrowing was used to finance the acquisition of assets and the imputed income is taxable. House mortgage interest payments are a particular case in point".

Interest and Inflation

11.21 In paragraph 11.10 we indicated that only real interest receipts should be charged to tax. Where the money rate of interest on borrowings is less than the rise in prices, i.e. where the real rate of interest is negative then, in principle, the real gain in spending power should be charged to tax. This is clear from the following simple example.

Example: We assume that inflation is running at a rate of 20 per cent and that the rate of interest is 15 per cent. An individual borrows £100 to purchase an asset which appreciates in line with the general price level. If we assume that the individual only pays interest during the year, the position is as follows:

	Beginning of year	End of year
Value of Asset	100	120
Loan Outstanding	100	100
Increase in Assets		20
Less Interest Paid		15
Increase in Real Value of Capital		5

11.22 To the extent that the change in the value of the asset held is different from the change in consumer prices, the adjustment to tax liability on the difference would be made when the asset is realised for capital gains tax purposes.

11.23 We asked the Revenue Commissioners for their views on the administrative implications of taxing the gearing gain arising from payment of interest. They considered that the administrative problem for them

would be manageable but at a certain cost. Most of the work would fall on financial institutions.

11.24 We recommend that the gearing gain arising from the erosion of the real value of monetary liabilities as a result of inflation should be charged to tax. As a first step towards achieving this end, we recommend that the deduction for tax purposes of interest on personal borrowings (including house purchase) should be withdrawn.

State Aid for House Purchase

11.25 We are conscious of the important role played by the deduction for mortgage interest in helping people to acquire their own homes. It is defective as constituted at present as it provides the greatest help to those in the higher income groups. However, its total abolition would disrupt the housing market and would be particularly severe on first-time house purchasers. Therefore, there is a need for an alternative.

11.26 During the course of our examination of the tax system in New Zealand, our attention was drawn to the "First Home Mortgage Rebate" scheme which was introduced there in April, 1981 in respect of first homes purchased or built on or after 1 April, 1976. The net effect of the scheme is to provide relief for first-time house purchasers during the first five years of their mortgage. After that no relief is given. We consider that a scheme on these lines would be a substantial improvement on the indiscriminate deduction of mortgage interest. The details of the scheme as it applied in New Zealand are set out in Appendix 9.

Exemption of Deposit Interest

11.27 Deposit interest exemption was first introduced in 1956 as an incentive to personal saving. At that time the first £25 of interest from the Post Office Savings Bank, the Trustee Savings Banks and certain commercial banks was exempted from tax. In 1960, the exemption was applied to the interest of each spouse in the case of a married couple, so that in effect the exemption available to them was in respect of £50 interest altogether. The £25 limit was raised to £50 in 1965 and to £70 (effectively £140 for a married couple) in 1967. The exemption limit in respect of interest earned on deposits with the Trustee Savings Banks and the Post Office Savings Bank was increased in 1980 to £150 (£300 for a married couple). The total amount exempted cannot exceed £150 or £300 as the case may be.

11.28 At present, the exemption applies to interest on deposits with

(i) the Post Office Savings Bank and the Trustee Savings Banks;

(ii) the Bank of Ireland, Allied Irish Banks Ltd., the Northern Bank Ltd., the Ulster Bank Ltd. and the National City Bank Ltd., and

(iii) Ansbacher and Co. Ltd., the Commercial Banking Co. Ltd. and Guinness and Mahon Ltd.

11.29 In its submission to the Commission, the Central Bank of Ireland recommended that

> "all deposit interest from all financial institutions should be taxed in full. This involves the abolition of tax-free limits, a measure which seems desirable on equity and efficiency grounds".

11.30 The Irish Banks' Standing Committee in a submission stated that an environment in which savings are encouraged is highly desirable. To achieve this it would be desirable if tax was only levied on a real rate of return on savings. The present situation where tax is levied on the nominal return, which is often a real loss, discourages saving and encourages expenditure. As an alternative to taxing a real rate of return on savings, the submission proposed that the real purchasing power of the exemption limit should be restored to its 1967 level (about £1,000) and thereafter annually adjusted in line with movements in interest rates and inflation. The limit should be applied uniformly to all deposit taking institutions.

11.31 The limitation of the exemption to a limited number of institutions was criticised by the Agricultural Credit Corporation Ltd..

11.32 The Department of Finance stated that

> "whatever the merit in the argument that deposits in all financial institutions should be treated equally for taxation purposes, it must be recognised that any move in this direction would weaken the position of the savings banks in competition for deposits unless the competitive edge of the savings banks were maintained by permitting higher deposit rates comparable with those accorded by commercial institutions with consequential increase in the cost of borrowing to the Exchequer. This could, in the long-term, be more expensive than the present incentives".[3]

11.33 We believe that it is in the interest of the community if the pattern of savings is not distorted by the application of the differential tax concessions to deposits. Accordingly, we recommend that the same treatment for tax purposes should apply to deposits with all deposit-taking institutions.

[3]Memorandum of 21 May, 1981.

Composite Rate Arrangement for Building Societies

11.34 The provision of finance for housing benefits from the tax arrangements which apply to building societies. These complement the encouragement to borrow for house purchase by providing an incentive to save through building society deposits. The procedure for collecting tax from building societies is based on an arrangement between the societies and the Revenue Commissioners under section 31 of the Corporation Tax Act, 1976. Under this arrangement, building societies pay interest to their depositors which is deemed to have borne tax at the standard rate. The societies pay income tax at the standard rate on distributions to companies and to persons with deposits in excess of £15,000.[4] On the remaining distributions, that is, to depositors with less than £15,000 on deposit, the societies pay income tax at a composite rate. The composite rate has, since 1959/60, been 70 per cent of the standard rate. Individual depositors account for any tax due at the higher rates. This is calculated on the net amount of interest received rather than on the gross amount after taking account of tax at the standard rate as would be appropriate.

11.35 The Revenue Commissioners are required under the legislation to ensure that the composite rate arrangements yield, "as nearly as may be", an equivalent amount of tax as would be payable if the arrangements did not apply. The Department of Finance informed us that

> "Due to lack of co-operation from the building societies the Revenue Commissioners have been unable so far to satisfy this statutory requirement and therefore are unable to determine whether the correct amount of tax is being paid. It has been necessary for the Commissioners to be given a statutory derogation from fulfilling this requirement in the Finance Acts of 1977, 1978 and 1980. The present derogation applied up to the end of the 1981/82 tax year. The indefinite continuation of this position would appear undesirable in principle".[5]

11.36 The Building Societies Association in a submission stated that they

> "are completely opposed to an investigation to arrive at the appropriate composite rate because they are convinced that it would have disastrous effects on investors' confidence in the societies. It has always been accepted by the investing public that savings with building societies are not subject to scrutiny by the Revenue".

11.37 The Building Societies Association favoured the continuation of the composite rate arrangement on the grounds that

[4]It is proposed to increase this figure to £30,000.
[5]Memorandum of 21 May, 1981.

(i) it is of great administrative convenience to both the building societies and the Revenue Commissioners;

(ii) because the composite rate is an average rate it will always be less than the standard rate of tax and as such permits the societies to charge a lower mortgage rate than would otherwise be possible;

(iii) the facility to pay a rate of interest on investments on which tax at the standard rate is deemed to have been paid is an important competitive element in attracting savings to building societies, and

(iv) the existing composite rate is likely to be higher than a true rate.

11.38 The effect of the composite rate arrangement is to enable building societies either to pay higher rates to their depositors than would otherwise be possible, thereby giving them a competitive advantage over other deposit-taking institutions, or to charge lower rates for mortgages, thereby increasing the demand for them, or some combination of the two. At the end of 1981, for example, building societies were paying 10.5 per cent on investments in share accounts, which was equivalent to 16.2 per cent before tax to an investor liable at the standard rate. The cost to the societies including their composite tax payment was 13.9 per cent. Were they to offer this amount to their depositors gross they might benefit from having a more attractive rate to persons not liable for tax who are at present not entitled to reclaim any part of the tax deducted under the composite rate arrangements. However, it is also possible that without the composite rate arrangement, building societies would have to pay a higher gross rate to attract the same amount of funds. This would seem likely to be reflected mainly in the rate charged for mortgages rather than in a reduction in building society margins.

11.39 The main justification for the composite rate arrangement is the administrative convenience to the Revenue Commissioners who are thereby enabled to collect tax from a relatively small number of societies rather than a large number of individuals. However, it distorts competition between the building societies and other deposit-taking institutions and adds to the bias in favour of housing over other forms of investment. The Revenue Commissioners would not favour such a system now if they were starting afresh and they have resisted the extension of similar arrangements to other institutions such as trustee savings banks. The resistance of the building societies to the carrying out of a statistical survey to establish a true composite rate has further undermined the basis for the arrangement. Furthermore, we believe it to be wrong for building society depositors who are not liable for tax, many of whom may be unaware of the true situation, to subsidise the taxpaying depositor or the house purchaser.

11.40 The subsidy to mortgage rates which results from the arrangement

benefits all borrowers from building societies regardless of need. We believe that State aid for house purchase would better contribute to the aims of housing policy if it were given selectively. We recommend that the composite rate arrangement should be terminated and the tax treatment of interest on building society deposits be aligned with that accorded to other interest-bearing deposits.

Relief to Individual Shareholders in Certain Irish Companies

11.41 Section 7 of the Finance Act, 1932 introduced a relief for individual investors in industrial companies carrying on business wholly or mainly in the State. In its original form, the relief applied to individuals who were resident solely in the State and were beneficially entitled to dividends or interest on stocks or shares issued for public subscription by limited companies resident in, and incorporated under the laws of the State. The relief provided that 20 per cent of the dividends or interest in question were to be disregarded for income tax purposes.

11.42 In 1935, the provisions were amended to bring them into line with the Control of Manufacturers Acts. The amendment provided that, in order to qualify for relief, over 50 per cent of the issued shares should be owned by Irish citizens or by companies controlled by Irish citizens. This provision was repealed in 1957.

11.43 In 1960, it was provided that the requirement that the stock or security should be issued after 4 August, 1932 (the date of the passing of the 1932 Finance Act) need not apply to manufacturing companies. Accordingly, the relief now applies to issues of manufacturing companies (which otherwise qualify) whenever they were made. The purpose of the latter amendments was to encourage investment in Irish manufacturing industries, to improve the marketability of existing Irish company shares and to assist the growth of an active capital market.

11.44 This relief has served the purposes for which it was introduced and is now unnecessary. Today, the demand for investment opportunities in publicly-quoted Irish companies exceeds what the market supplies. We recommend that the relief be abolished. This would improve both the equity and simplicity of the tax system.

Relief on Dividends Paid out of Export-relieved Profits

11.45 Tax relief for profits from exports was introduced in 1956. When bringing in the measure, the Minister for Finance said that it was occasioned by the paramount necessity at the time for everything possible to be done to stimulate production and exports arising out of increased production. The relief is due to expire on 5 April, 1990. With the exception of cases in

which assurances have been provided by the Industrial Development Authority, no company commencing to trade after 1 January, 1981 will qualify for the relief. We recommend that this arrangement be unaltered.

Relief for Superannuation Contributions

11.46 Saving through the medium of pension funds is encouraged in several ways. Firstly, provided a fund meets a number of criteria which enable it to be approved by the Revenue Commissioners, employees' contributions are deducted from their gross pay before taxable income is calculated. Employers' contributions are an allowable deduction from taxable profits as part of labour costs. Comparable relief for the purchase of an approved retirement annuity applies to the self-employed. Secondly, no tax is levied on the investment income or capital gains of an exempt fund. Thirdly, though regular payments of pensions out of a fund are taxed as earned income at the time they are received, up to 1½ times final pay may be taken at the time of retirement as a lump sum free of tax.

11.47 The principle of relief for superannuation contributions was recommended in general terms by the Royal Commission on the Income Tax, 1920 and was enacted in 1921. The law provides that to qualify for tax benefits, superannuation schemes must be approved by the Revenue Commissioners. The main rule with which approved schemes must conform is that the pension must be accumulated at the rate of one-sixtieth of final salary for each year of service up to a maximum of two-thirds of final salary. In addition, roughly a quarter of the value of the benefits may be commuted into a tax-free lump sum.

11.48 The rules permit favourable treatment for persons moving to new employment late in their career, enabling them to accumulate a full pension within the last ten years of service. However, employees are required to serve twenty years to get the maximum lump sum of 1½ times final earnings. There is a sliding scale covering shorter periods. Schemes may provide life insurance cover for death in service up to four times the annual pensionable salary. There is also provision for benefits to spouses and dependent children.

11.49 The justification for giving tax concessions for pensions depends largely on the desirability of encouraging individuals to make provision for their retirement, though a large part of pension savings is now virtually compulsory. In effect, saving through a pension fund is a means of redistributing income over a lifetime. Income received while at work is set aside, untaxed, to provide income during retirement, when it is taxed as earned income as it is received. The relief of tax on the income and capital gains of pension funds contrasts markedly with the tax treatment of an individual

who saves privately for his retirement instead of through institutional channels.

11.50 We asked the Department of Finance for the justification of the limitations on the size of pensions relative to pay that are imposed before schemes are approved, thereby qualifying for tax benefits. They replied that from the outset the yardstick for maximum benefits has been the level of benefits provided under statutory schemes. The abolition of all limits on the amount of contributions allowable on the grounds that the pensions are taxable would be costly.

11.51 Under a comprehensive income tax, the logical treatment of superannuation contributions would be to withdraw the existing concession whereby employees' contributions to pension funds may be deducted for tax purposes. It would also be necessary to attribute employers' contributions to members of a fund and assess them on their share. Pensions would then have to be divided into two parts, one of which was taxable and the other tax-free, along similar lines to those currently used for purchased life annuities. The tax-free element would derive from the contributions while the taxable amounts would represent income and capital gains in periods subsequent to the making of contributions

11.52 Such treatment would cause many difficulties. In many pension schemes, employers' contributions are not allocated to individual employees and any such allocation would be arbitrary. In addition, substantial "topping-up" payments by employers would lead to employees facing irregular tax bills without having the cash to meet these payments. There would also be administrative difficulties in tax offices. In the majority of schemes approved by the Revenue Commissioners, the provision of benefits is conditional on employees serving to retirement age. If an employee leaves before reaching retirement age, entitlement to benefit is lost. While many schemes provide for a return of the employee's own contributions, no credit is given for the employer's contribution attributable to that employee. In equity, the tax payable on the additional income imputed to the employee in respect of employer's contributions would have to be repaid. This could involve revisions of liability over many years.

11.53 When pensions are not fully transferable, labour mobility is inhibited. This has undesirable economic consequences. While the transferability of pension arrangements is a matter which will arise for consideration in the context of the development of a national income-related pension scheme, it is outside the scope of this report. However, we are concerned with the equity aspects of the present system. In order to end the existing discrimination against individuals who change employment, we recommend that any approved pension scheme should refund to an individual who is leaving an employment a lump sum equal to the total contributions

made on his behalf plus interest earned thereon. This refund of contributions should be charged to tax in full. If the lump sum is subsequently reinvested in some other approved pension arrangement, the tax deducted should be refunded.

Retirement Annuities

11.54 Certain reliefs are granted in respect of contributions towards approved retirement annuities by self-employed persons. The reliefs are analogous to those granted in respect of retirement benefits schemes for employees. The main difference is that reliefs in the case of superannuation schemes are subject to the schemes providing not more than a specified level of benefits, whereas in the case of retirement annuities it is the contributions towards the annuity which are subject to limitation.

11.55 Approved schemes provide life annuities for an individual commencing not earlier than age 60 and not later than age 70, but the annuities may be deferred or taken earlier in certain cases, the upper age limit being 80 and the lower 50. The maximum relief is 15 per cent of "net relevant earnings". The premiums may be varied from year to year depending on the net relevant earnings of the individual and payment may be suspended for a while. This is made possible by paying single as opposed to annual premiums.

11.56 Net relevant earnings are earnings from trades, professions and non-pensionable employments less certain payments and deductions. The earnings of a husband and wife are treated separately for purposes of determining relevant earnings and the relief is available in respect of each spouse with non-pensionable earnings. In addition to funding for a retirement income, an individual can obtain tax relief on up to 5 per cent of net relevant earnings in providing for a widows' pension or lump sum death benefit.

11.57 A submission from the Life Offices' Association of Ireland argued that

> "A self-employed person obtains income tax relief for premiums paid in respect of personal retirement pension policies up to a maximum of 15 per cent of his net relevant earnings. This is at variance with the position under pension schemes organised by individual companies where the limit placed on the amount of the premium payable is computed by reference to the projected benefits which are payable under the scheme. Invariably a higher pension can be provided by using this latter method, and this creates discrimination against the self-employed person who may not be able to incorporate his business. We believe that the 15 per cent limit should be increased so as to enable the self-employed person to provide the same amount of pension for himself as if he were in pensionable employment".

11.58 The restrictions on the amount of superannuation contributions allowable for tax purposes are designed to prevent avoidance of tax particularly at the higher rates.

> "The function of the Revenue Commissioners in relation to retirement benefits is principally to protect the revenue".[5]

11.59 We consider that the present restrictions on the proportion of income which may be devoted to purchasing retirement annuities discriminate against self-employed persons. We recommend that the arrangements for the self-employed and the employed be brought into line with each other. Our proposals for a single rate of income tax would ensure that the use of annuities for purposes of tax avoidance would be minimised. The need for restrictions would be reduced greatly, given the existing justification for them.

Individual Retirement Accounts

11.60 To benefit from the tax incentives for superannuation, the investment has to be in an exempt approved scheme which is normally administered by a merchant bank or a life assurance company. This has the effect of channelling long-term savings through these institutions to an extent which would not take place in the absence of such restrictions. We do not believe that these restrictions are conducive to the efficient allocation of savings. In the United States, for example, employees already covered under in-house pension schemes can top up their pension benefits by investing in individual retirement accounts. Such accounts, for example, can be opened in a bank and the returns earned are deferred until after the age of 59½ when they are eligible for withdrawal. Similar type accounts, known as "Keogh" accounts, exist for the self-employed where the amount eligible for investment is 15 per cent of income, compared to a maximum of $2,000 ($4,000 for a married couple) in the individual retirement accounts. These arrangements greatly expand the range of institutions and instruments through which people can invest for pensions. Such an expansion would improve the efficiency of the capital markets and we recommend that of a similar type of arrangement be considered for Ireland.

Relief for Life Assurance Premiums

11.61 In computing liability to income tax, an allowance is made for

[5] *A National Income Related Pension Scheme*, Green Paper, Pr. 5737, 1976, para 61.

insurance premiums payable by a person on his or her own life or on that of their spouse. There are a number of restrictions on the amount of the deduction. The premiums eligible for relief cannot exceed one-sixth of the total income of the individual for the year and the annual allowance on each policy is limited to 7 per cent of the capital sum payable on death. In the case of policies effected after 2 April, 1974, the maximum admissible premium is £1,000. As and from 1980/81, this amount has been increased to £2,000 in the case of a married couple electing for joint assessment. In the case of an endowment policy issued after 16 May, 1973, relief is conditional on the term of the assurance being for a minimum of ten years. The proceeds of the policies are exempt from all forms of taxation on maturity.

11.62 Relief for life assurance has a long history. In 1799 when Pitt introduced income tax he added a provision allowing a tax reduction for life insurance premiums. At that time earned and unearned incomes were treated alike for income tax purposes and life assurance relief was intended to mitigate the hardship caused by imposing tax on incomes which were mainly earned and therefore "precarious". In 1806, the relief was restricted to persons whose incomes did not exceed £150 per annum. This continued until the income tax was repealed in 1816.

11.63 The relief was not reintroduced into the income tax code until 1853. At that time it was regarded as an alternative to an earned income allowance. In 1907, differentiation was introduced in favour of earned income but the relief for life assurance premiums was not disturbed, although there was some opposition to the granting of both earned income relief and life assurance relief simultaneously.

11.64 Following the report of the Royal Commission on the Income Tax in 1920, the allowance for premiums on policies taken out after 22 June, 1916 was restricted to one-half the standard rate of income tax. The relief for life assurance premiums has been continued in Ireland since the foundation of the State. In 1953, the relief was increased to two-thirds instead of one-half the standard rate on new policies taken out with any company registered and managed and controlled in the State. Following the unification of income tax and sur-tax in 1974, the appropriate fraction of life assurance premiums was allowed as a deduction from total income. This had the effect of giving the relief at the marginal rate of tax from 26 per cent to 80 per cent instead of at the standard rate of 35 per cent as had previously been the case. To maintain the differential in the case of taxpayers liable at the higher rates that previously existed between post-1953 Irish policies and other policies, the fraction of premiums allowable on all policies was increased to two-thirds of the difference between the marginal rate of tax and the standard rate. One half of the premiums continued to be allowed at the standard rate. The relief on Irish policies taken out on or after 2

February, 1978 was reduced to one-half of the qualifying premiums. This rate of relief now applies to all new policies.

11.65 To summarise, life assurance relief is available as follows:

(i) In the case of policies taken out before 22 May, 1953 or after 1 February, 1978 the allowance is one-half of the premium.

(ii) In the case of policies taken out with an Irish company between 22 May, 1953 and 1 February, 1978 the allowance is two-thirds of the premium.

(iii) In the case of policies taken out with a non-Irish company between the dates referred to in (ii) the allowance is one-half of the premium. Where, however, an individual is liable to tax at a rate in excess of the standard rate, relief is increased by an amount equal to one-sixth of the premium at a rate equivalent to the difference between the taxpayer's marginal rate and the standard rate.

11.66 Initially, life assurance was designed chiefly to provide benefits to dependants on the death of the person whose life was assured. However, a wide variety of alternative ways to make this provision now exist. The State provides a range of social insurance pensions. Occupational pension schemes are the norm and retirement annuity schemes are available to the self-employed. A National Income-Related Pension Scheme is in the course of preparation.

11.67 Over the years life assurance has developed as an important medium for personal savings. Most policies are now of the endowment type, that is to say, they call for payment to be made after a specified period of years or on earlier death of the insured. The mortality risk element in the premium for such policies is relatively small and the bulk of the premium can be regarded as contractual savings.

11.68 Many policies are now sophisticated forms of investment where, in effect, the capital invested qualifies for income tax relief and the proceeds, on maturity or surrender, are free of personal income tax and capital gains tax. Tax relief for savings in the form of life assurance premiums is therefore especially generous.

11.69 The Life Offices' Association of Ireland, in a submission, argued that the benefits and the contribution made by life assurance are so important that it is proper to provide tax incentives. The impact of inflation has tended to deter people from long-term saving at a time when the needs of the public and the economy for such saving is increasing. The submission said that the £1,000 limit on allowable premiums introduced in 1974 has been

seriously eroded by inflation and should be removed. An opposing view was taken by the Irish Taxes Union which urged the abolition of the relief.

11.70 It may be argued that to reduce the attractiveness of life assurance relative to other forms of saving would have serious effects on the pattern of investment. In 1980, the gross life assurance premiums within Ireland amounted to £170.4 million. Claims and surrenders amounted to £78.6 million leaving net premiums at £91.8 million. An indication of the investment of these funds may be gained from Table 15 which sets out the change in the distribution of assets of Irish companies for life assurance business between 31 December, 1979 and 31 December, 1980.

TABLE 15

Changes in the Stock of Assets of Irish Companies for Life Assurance Business in 1980

Type of Asset	Percentage of Total Increase in Assets
	%
Loans and Mortgages	−0.1
Government Securities	20.4
Shares etc.	39.5
Property	19.7
Cash in hand and at Bank	14.2
Others	6.3

Source: Assurance Companies 1979 and 1980, Department of Trade, Commerce and Tourism Pl. 146, Derived from Table 12.

11.71 It is not clear that the investment of funds by assurance companies is superior in economic or social terms to that undertaken by other institutions. We see no reason on these grounds for special treatment of such savings for tax purposes.

11.72 Life assurance is a form of saving. Under an income tax system no special relief should be allowed in respect of contributions and the proceeds of policies on maturity should be free of tax. To give preferential treatment for savings in the form of life assurance premiums would discriminate against other forms of saving and lead to distortions in the allocation of resources. We recommend that life assurance be governed by the same provisions as other forms of saving. On this basis, we consider that the existing relief for life assurance premiums should be withdrawn.

National Savings Schemes

11.73 Income received from money invested in national savings schemes

such as savings certificates, national instalment savings and savings bonds is exempt from income tax. The present concessions which are regarded as incentives are largely insufficient to compensate holders for the effects of inflation, except in the case of certain limited schemes. We recommend that our general proposals in relation to the taxation of income from savings apply to them. This would result in more favourable treatment of national savings in most cases.

Recommendations

11.74 We make the following recommendations:

1. Income from all interest-bearing deposits should be charged to tax to the extent only that the rate at which it accrues exceeds the rate of inflation during the period of accrual.
2. The gearing gain arising from the erosion of the real value of monetary liabilities should be charged to tax. As a first step towards achieving this end, the deduction for tax purposes of all interest (including that relating to house purchase) should be withdrawn for personal taxation. [We set out in Appendix 9 an alternative scheme of aiding first-time purchasers of houses].
3. The same treatment for tax purposes should apply to deposits with *all* deposit-taking institutions.
4. The composite rate arrangement for the taxation of interest on building society deposits should be ended.
5. The 20 per cent relief for individual investors in certain industrial companies should be ended.
6. Dividends paid out of profits which qualify for export sales relief should continue to be free of tax.
7. Any approved pension scheme should refund to an individual who is leaving an employment a lump sum equal to total contributions made on his behalf plus interest earned thereon. The refund of contributions should be charged to tax in full. If the lump sum is subsequently reinvested in some other approved pension arrangement, the tax deducted should be refunded.
8. The present restrictions on the proportion of income which may be devoted to purchasing retirement annuities discriminate against self-employed persons and should be brought into line with those applying to employees.
9. As an alternative to approved pension schemes and retirement annuities, individual retirement accounts on the lines set out in paragraph 11.60 should be considered.

10. Income tax relief in respect of life assurance premiums should be withdrawn and such premiums governed by the same provisions as other forms of saving.

11. Income from national savings should be charged to tax in the same way as income from other savings.

CHAPTER 12

THE TAXATION OF FRINGE BENEFITS

Introduction

12.1 In this chapter we consider the treatment for tax purposes of income which is received in kind and which cannot be converted into money. Our general approach is that such income should bear the same amount of tax as would its equivalent in the form of money, if paid directly to the recipient. The existing taxation treatment of fringe benefits is favourable in relation to that accorded to ordinary income. Reform is essential.

12.2 The available evidence suggests that the use of fringe benefits has increased in recent years. This is due, at least in part, to the tax advantages derived from receiving certain income in kind rather than its equivalent in money terms. We regard the proliferation of fringe benefits as undesirable and a distortion of the market. Employees' expenditure is effectively forced into directions which they might not choose were it not for the favourable tax treatment. This leads to waste. It is also arguable that fringe benefits cause resentment among employees who do not qualify for them.

Definition

12.3 The phrase "fringe benefits" is normally taken as referring to any benefits, not in the form of money, which an employee derives from an employment. These are benefits given in addition to salary, bonus and commission and have the effect of increasing the employee's command over economic resources. The most common form of fringe benefit is the use of an employer's car. We use the term fringe benefits, in a wider sense, to include fringe benefits as generally understood and also certain cash benefits such as the remuneration content in a generous expense allowance or a cash prize or gift given by an employer to his employee. The definition is further extended to include non-money benefits provided for shareholders by a company since many of the arguments which relate to fringe benefits derived from an employment can be applied to this type of benefit also.

12.4 Over the years the scope of the Schedule E charging provisions became the subject of numerous appeals to the Courts. Decisions by the Courts established a number of important principles. These included

(i) Benefits, although derived from an employment, could not be regarded as perquisites chargeable under Schedule E unless they were capable of being converted into money by the employee or office holder.

(ii) While a cash allowance on account of personal expenses could be charged to tax as an emolument,[1] it was by no means clear that a cash allowance on account of business expenses could be so charged.

12.5 In 1958, all expenses payments became chargeable, subject to the normal expenses deductions under the rules of Schedule E, and the benefits which would otherwise have escaped taxation became chargeable as benefits-in-kind. The charging provisions took effect for the first time in 1959/60. They applied in general to directors of companies and other bodies which were engaged in trade or holding investments or other property. They affected also certain employees of such companies or other bodies and certain employees of an individual or partnership carrying on a trade, profession or vocation. The employees concerned are those engaged in employment, the emoluments of which (including expenses payments and benefits-in-kind) amount to £1,500 or more in the year.

12.6 In 1973, it was provided that a deduction in respect of a payment made to an employee for business entertaining may be disallowed to the employer. Nevertheless, an employee is chargeable under Schedule E in respect of the payment unless he can show that he expended the money wholly, exclusively and necessarily in the performance of the duties of his employment.

12.7 The scope of the benefits-in-kind legislation was extended in 1973 to cover expenses payments and benefits-in-kind made available to employees of bodies not engaged in trade such as local authorities, Government departments, State-sponsored bodies, trade unions and charities. These provisions were extended further in 1976 to cover expenses payments and benefits arising to a person in receipt of remuneration assessable to tax under Case III of Schedule D as if the expenses or benefit arose to a person assessable under Schedule E. Virtually all employees are now within the benefit-in-kind charging provisions.

Benefits Chargeable

12.8 The following is a list of fringe benefits, that is, expense allowances and benefits-in-kind which are chargeable to tax under existing legislation:

[1] *Revelle v Elsworthy Bros & Co. Ltd* and *Ferguson v Noble*.

(i) Payments for expenses subject to any deductions allowable under the Schedule E expense rule;[2]

(ii) Living or other accommodation including the cost of repairs, light, heat and rates, entertainment and domestic or other services;

(iii) The use of any other asset, for example, car or furniture, owned by the employer;

(iv) Transfer at undervalue of the property in any asset, for example, car or dwelling house, from the employer to the director or employee;

(v) Any expenses or liabilities paid directly by the employer for a director or employee, for example, hotel accommodation, hotel bills, or running costs of maintenance of a car, if not already included in expenses payments, and

(vi) Any other benefits or facilities of whatsoever nature.

Benefits not Chargeable

12.9 The following benefits were specifically excluded from the scope of the 1958 charging provisions:

(i) Accommodation (including supplies and services) provided for a director or employee and used by him solely in performing his duties;

(ii) Living accommodation provided for employees other than directors which the employee is required by the terms of his employment to occupy for the purpose of enabling him properly to perform his duties (for example, bank officials residing on bank premises), and

(iii) Meals in a canteen in which meals are provided for the employer's staff generally.

Examples of benefits outside the scope of the charge to tax, by reason of the operation of provisions in the 1958 legislation, which require benefits to be valued for the purpose of charge by reference to the cost to the employer of providing them, are cheap or free travel facilities for employees of travel firms, cheap university fees for relatives of the teaching staff of the university and preferential interest rates on loans to employees of financial concerns.

[2] The rule is:
"If the holder of an office or employment of profit is necessarily obliged to incur and defray out of the emoluments thereof the expenses of travelling in the performance of the duties of the office or employment, or of keeping and maintaining a horse to enable him to perform the same, or otherwise to expend money *wholly, exclusively and necessarily* in the performance of the said duties, there may be deducted from the emoluments to be assessed the expenses so necessarily incurred and defrayed". (Rule 3, Schedule 2 to the Income Tax Act, 1967).

Operation of Existing Legislation

12.10 We asked the Revenue Commissioners if they thought the existing legislation on benefits-in-kind was satisfactory. They replied in the following way:

> "In general the present system of valuation of benefits-in-kind in terms of cost to the employer operates satisfactorily except in two main areas, namely, the valuation of the benefit of the use of a motor car and the treatment of benefits such as preferential loans, cheap transport facilities and free education, the true cost of which to the employer cannot be readily quantified. From the point of view of administration the present system is very time consuming and is incapable of producing a tax yield in any way comparable with the revenue lost through the payment of lower monetary remuneration to employees in receipt of fringe benefits".[3]

Taxation of Benefits

12.11 It is necessary to establish a framework within which fringe benefits may be taxed. In general, under existing Irish legislation, the employee is charged to tax on an amount equal to the cost to the employer of providing the benefit. However, there are exceptions to this rule. For cars and other assets, the value is annual value of the use of the asset which, in practice, is taken to be an appropriate proportion of the historical cost. For residential accommodation, where the employer pays no rent, the annual value is taken to be the annual rental value of the property.

12.12 The Carter Commission[4] adopted four rules which provide a satisfactory framework for the taxation of fringe benefits:

(i) Whenever possible the employee in receipt of a non-cash benefit should be charged to tax on what the benefit would cost if he purchased it in the open market and not on the cost to or revenue foregone by the employer.

(ii) It must be assumed that the recipient of a non-cash benefit had a choice between the non-cash benefit and the receipt of a taxable cash payment equal to the cost which would be incurred if the benefit were purchased in the market.

(iii) When, in the course of carrying out his work, an employee is provided with consumer goods and services by his employer, there may be an element of personal benefit. Because the market value of the personal benefit in each case cannot be ascertained on a simple and consistent basis, there should be arbitrary limits on the costs of such goods and services which are regarded as expenses of earning income. A living expense of an employee paid by an employer in excess of these limits would be deemed to be a personal benefit to the employee and he would be charged to tax accordingly.

(iv) Where a common facility provides benefits-in-kind to a number of individuals simultaneously, the market value of the benefit provided by the facility should be included in the incomes of those who enjoy it, according to their relative benefit.

[3] Letter of 13 March, 1981.
[4] *Report of the Royal Commission on Taxation*, Canada, Vol. 3, p.286.

Frequency of Fringe Benefits in Ireland

12.13 Data on the frequency of the major fringe benefits granted to Irish executives are published annually in the Inbucon management consultants survey of executive salaries and fringe benefits.[5] This survey obtained information as at July, 1981 in relation to companies in the Republic of Ireland. Table 16 shows the change in the frequency of fringe benefits in the period 1975 to 1981.

TABLE 16

Fringe Benefits 1975-81

Benefits	Percentage of the sample receiving benefits in						
	1975	1976	1977	1978	1979	1980	1981
	%	%	%	%	%	%	%
Full use of company car	48	46	46	49	53	55	57
Allowance for regular use of own car	17	19	21	18	19	11	13
Subsidised lunches	44	46	47	40	36	32	46
Subsidised housing	1	4	1	1	1	1	1
Assistance with house purchase	6	5	12	10	8	5	14
Life Assurance							
—up to and including three times salary	21	32	35	37	49	34	34
—exceeding three times salary	32	29	33	39	28	45	42
Free medical insurance	18	18	20	20	21	32	29
Share option scheme	7	5	1	3	5	5	7
Share purchase scheme	5	3	4	3	2	6	6
Low interest loans	no data	3	10	5	3	5	14

Notes: "Subsidised housing" means use of a company house etc.
"Assistance with house purchase" covers mortgage loans at reduced rates etc., other than when moving at the company's request.
"Share option scheme" is a scheme where those included become shareholders on favourable terms and is sometimes called a share incentive scheme.
"Low interest loans" means loans for any purpose other than housing.

[5] *Survey of Executive Salaries and Fringe Benefits in the Republic of Ireland*, October, 1981, Salary Research Unit, Inbucon Management Consultants.

12.14 The increasing provision of fringe benefits by employers is confirmed by a 1980 survey by the Irish Management Institute which states

> "At present, it would seem that most (91 per cent) of the companies responding supply cars for their chief executives, 77 per cent would do so for the head of function, while about 40 per cent supply vehicles to executives in senior management positions. 12 per cent of firms supply cars to middle management. The figures have all increased on 1979. In most cases where a car is supplied, the company pays for insurance, tax, service and repairs. Over half supply petrol for business mileage only, while the remainder would supply all petrol."[6]

Discounts to Shareholders

12.15 A practice has developed in recent years of shareholders in certain companies being offered discounts on the company's products. A ready example may be found in the insurance industry where it is known that in one case substantial discounts on insurance premiums are given to shareholders. While the practice of giving discounts to shareholders has not yet developed to any great extent in Ireland, it is growing rapidly in the United Kingdom. A report by stockbrokers, Grieveson, Grant and Co., lists more than 70 quoted companies which provide discounts to their shareholders. It is conceivable, in the light of this experience, that the practice will grow in Ireland.

Scheme for Taxation of Fringe Benefits

12.16 We recommend that fringe benefits be taxed on the basis that the "market value" of property, services, or facilities furnished by an employer in connection with the performance of services must be included in the recipient's gross income. "Market value" is the amount that the recipient would have to pay in an arm's length transaction to purchase the same or an equivalent item or its use. Exceptions need to be provided from this general rule in respect of working conditions and for reasons of administrative convenience. Our approach to these exceptions is as follows:

(i) *Working conditions:* We consider that the value of a service or facility provided to facilitate the performance of an employee's duties should be excluded from an employee's gross income as a working condition. Generally, a working condition is provided at the place of employment for use during normal working hours. The fact that a particular item is not required for the performance of an employee's duties would not necessarily exclude it as a working condition. Examples of the items we have in mind are the decoration of offices and first aid services provided by employers.

(ii) *Administrative convenience:* The tax law requires a reasonable balance to be struck between the achievement of equity between taxpayers and of economic efficiency on the one hand and the avoidance of undue burdens in administering the law on the other. Accordingly, we have felt it necessary to lay down guidelines for determining when the value of an item, which should in principle be included in gross income, should be excluded for reasons of administrative convenience.

[6] *A Survey of Executive Salaries and Fringe Benefits in Ireland 1980*, Irish Management Institute, page 37.

Market Value

12.17 Fair market value is the amount that the recipient of a benefit would have to pay in an arm's length transaction to purchase the same or an equivalent item or its use. The determination of fair market value will depend on the facts and circumstances of each case. The relevant factors include

(i) conditions and restrictions placed on the purchase or use of a particular item;

(ii) the price charged for the item or its use to customers who are not employees, independent contractors, or otherwise providing services to the employer, and

(iii) whether an equivalent item is ordinarily purchased by the general public on an arm's length basis and, if so, at what price.

12.18 In general, we consider that the Revenue Commissioners should keep the taxation arrangements applying to benefits-in-kind under review. They should concentrate on bringing into charge the most important items. Where benefits are small or their inclusion would create disproportionate administrative problems, *de minimis* provisions should be applied. An important factor in deciding whether or not to exclude a fringe benefit from the charge to tax should be whether or not the item is available on a non-discriminatory basis, that is, whether access to the item is dependent upon the recipient's employment status, job classification or salary level.

Types of Benefits

12.19 In the following paragraphs we set out the types of benefits-in-kind that are commonly provided. We give details of their treatment for tax purposes under existing legislation and outline the changes which we believe are necessary on the basis of the principles we have adopted in paragraph 12.12.

Cars

12.20 It is fairly common practice in Ireland to provide company cars for middle and senior management without restrictions on their use. The popularity of this benefit may be due, at least in part, to its tax advantages for the recipient. To arrive at the value of the remuneration represented by a company car, the Revenue Commissioners estimate the annual value of the car as a fixed percentage of the purchase price of the car, plus the annual costs of licence, insurance, running and maintenance, but excluding any interest payments arising from borrowing to purchase the car. This total is divided in proportion to business and personal mileage during the year, and the income value of the car to the individual is assessed as the share imputed to personal mileage less any contribution towards costs made by the employee.

12.21 Where a car is provided by his employer, whether or not it is used for business purposes, an employee receives a tax benefit. The factors giving rise to the benefit include:

(i) For 1981/82 and earlier years, the annual value of the car was taken at 12½ per cent of the historical cost. Market depreciation would normally be greater than this;

(ii) The funding or interest cost of providing the car is ignored;

(iii) The element of private use may be understated in many instances, and

(iv) The provision of a car may relieve the employee of the full standing charge of providing his own car. No account is taken of this factor.

12.22 Because of the tax advantages which arise from the provision of a car to an employee as opposed to granting him an equivalent increase in pre-tax remuneration, it is to be expected that the frequency with which cars are provided would increase as income and therefore marginal tax rates rise. Table 17 shows that this is the case.

12.23 The Revenue Commissioners have informed us that in relation to the valuation of use of a motor car a great deal of time is spent in discussion and argument between the inspector of taxes and the taxpayer or his agent. In order to get cases settled, the inspector of taxes invariably has to agree to a value substantially below the true level of benefit. The inspector is obliged to take account of a number of factors: the cost price of the car, the

TABLE 17

Company Cars By Salary Level

Salary Bracket	No. and percentage of those in each salary bracket having full use of a company car		Total no. of executives in each salary bracket
		%	
Up to £9,999	48	18.5	259
£10,000 to £14,999	390	52.8	739
£15,000 to £19,999	272	80.7	337
£20,000 to £24,999	114	89.1	128
£25,000 to £29,999	28	96.6	29
£30,000 and over	12	100.0	12
Total	864	57.4	1,504

Source: Survey of Executive Salaries and Fringe Benefits in the Republic of Ireland. Salary Research Unit, Inbucon Management Consultants, October, 1981.

amounts paid for tax, insurance, servicing, repairs and replacements, and the consumption of petrol and oil. The main difficulty, however, is the apportionment on the basis of private and business mileage for the year. The private mileage is frequently understated and when it is there is very little the inspector can do to have the true position established.

12.24 In an attempt to overcome some of these defects and particularly to ease the administrative difficulties mentioned in paragraph 12.21 (iii), a change in the method of computing the benefit-in-kind arising from the provision of a car was made in 1976. This imposed a minimum charge of £300 or 15 per cent of the purchase price of the car, if greater. This change met with widespread opposition from users of cars provided by employers and was repealed in 1978.

12.25 In his budget speech on 25 March, 1982 the Minister for Finance again announced changes in the taxation arrangements applying to cars provided for an employee's private use. Further modifications have been proposed in the Finance Bill, 1982. These proposals are designed to counter tax avoidance through the payment of remuneration in the form of cars, which was completely undervalued for tax purposes. For 1982/83 and subsequent years, the taxable benefit arising from the private use of a car provided by an employer will be calculated as a percentage of the original market value of the car. The percentage will vary from 12½ per cent where the car only is supplied, to 20 per cent where all costs are met by the employer. Where the business mileage is more than 10,000 miles in a year a system of tapering relief will apply. Where the business mileage exceeds 25,000 miles, there is no charge by way of benefit-in-kind.

12.26 We consider that the correct method of valuing the benefit is by reference, not to the cost to the employer, but the value to the employee. The cost of financing the purchase of the car should also be taken into account, as well as the depreciation allowance granted to the employer, which we propose should be on an indexed basis. So also, as far as is possible, should the benefit to the employee of being relieved of the need to purchase a private car for personal use. Because of the administrative difficulties inherent in determining accurately the benefit-in-kind in each individual case we see little alternative to scale benefits. We recommend that the employer be afforded the right of appeal where he feels aggrieved with the application of scale benefits in his particular circumstances.

12.27 The proposed changes in the tax treatment of cars provided by an employer have implications for taxation in cases in which the employees use their own cars partly for business purposes and are reimbursed on the basis of a fixed rate per mile. We recommend that the Revenue Commissioners publish a scale of mileage allowances which they would accept as containing no element of remuneration. Such allowances should take account of the fact, particularly in cases of relatively low business mileage, that the fixed costs of the car would have been incurred in any event. It follows that, where a mileage allowance in excess of the scale rate is paid to employees for using their own cars, the excess should be charged to tax. The scale of mileage allowances should be consistent with the scale of benefits referred to in the preceding paragraph.

Loans at Preferential Rates of Interest

12.28 Loans at preferential rates of interest are available to certain employees for housing and other purposes. This facility mainly applies to employees in the financial sector.

12.29 Interest is allowed for tax purposes on a limited basis as set out in paragraphs 11.16 and 11.17. When interest relief is restricted, loans of substantial amounts at reduced rates of interest confer a tax advantage in certain circumstances when compared with an equivalent salary increase given to an employee who pays commercial rates of interest. In the case of a married employee earning £25,000 per annum who obtains a loan of £50,000 from his employer (B) at 2 per cent compared with a commercial rate of 14 per cent, the reduction in the rate of interest is worth £50,000 at 12 per cent — £6,000 — to the employee (A) in gross salary terms. Table 18 shows the benefit of the preferential loan to the employee.

TABLE 18

Benefit of Preferential Loan to Employee

	A (Preferential rate applies)	B Cost to employer to maintain net after tax income of employee
	£	£
Salary	25,000	34,000
Personal reliefs	2,830	2,830
	22,170	31,170
Interest disallowed	(200)	(2,200)
Interest allowed*	800	4,800
Taxable Income	21,370	26,370
Tax	9,072	12,072
Net income after interest and tax	14,928	14,928

* Part of the benefit arising from cheap loans was limited for the first time in Ireland in 1979. The position now is that the ceiling on allowable interest is reduced in the proportion which the actual interest due on preferential loans bears to the interest which would have been payable if interest were payable at the specified rate of 12 per cent. The Finance Bill, 1982 proposes that employers will be charged to tax on any amount representing the difference between the amount of interest paid and the amount of interest paid at the specified rate of 12 per cent. The amount of interest so charged will be treated as if it were, in fact, interest paid by the employee and will generally qualify for relief subject to the normal restrictions on the allowability of interest.

In the foregoing example the restriction operates as follows:

Interest normally allowable	£4,800
Specified rate	12 per cent
Interest due on preferential loan	£1,000
Interest payable if loan had been at 12 per cent	£6,000
Fraction	$\frac{1}{6}$
Interest allowed	£4,800 × $\frac{1}{6}$

The interest allowed is restricted from £1,000 to £800. The preferential loan which results in a saving in interest of £6,000 is equivalent to a pre-tax increase in salary of £9,000.

12.30 In the United Kingdom, legislation enacted in 1976 introduced provisions to tax the benefit which arises when a director or higher paid employee obtains an interest-free or low-interest loan from his employer. Broadly speaking, the benefit is calculated by comparing the interest actually paid on the loan with notional interest at the "official rate" — a rate fixed from time to time by the Treasury. There is also a *de minimis*

exemption below which the benefit is ignored, and no benefit arises where, had it been paid, all the interest would have been tax-deductible (e.g. the interest payments on mortgages up to £25,000). The official rate is currently 15 per cent and the *de minimis* exemption stands at £200 a year. There was no official rate before 6 April, 1978 so, where a loan was obtained before that, the market rate of interest is used as a standard.

12.31 The Revenue Commissioners have advised us that the present system "which provides for a proportionate reduction in the limit for allowable interest only goes part of the way towards providing equality of tax treatment for all borrowers".

12.32 We recommend that the benefit arising on loans to employees at preferential rates of interest should be charged to tax. The benefit should be calculated as the difference between the amount of interest payable at the preferential rate and that payable at either commercial rates or the rate of inflation whichever is the greater.

Living Accommodation

12.33 The benefit arising from the occupation of living accommodation provided for an employee which he is required by the terms of his employment to occupy for the purposes of performing his duties is not charged to tax under existing law. The provision of such accommodation relieves the employee of the need and expense of providing accommodation for himself. We believe that the provision of such accommodation is of value to the employee and should be charged to tax to that extent.

Insurance

12.34 Insurance appears as a fringe benefit where premiums are paid on behalf of the employee by the employer. We consider this form of benefit under five headings as follows:

(i) Medical insurance schemes.

(ii) Permanent health benefit schemes.

(iii) Term life assurance.

(iv) Endowment life assurance.

(v) Superannuation benefits provided in the form of life assurance.

Medical Insurance

12.35 Premiums paid by an employer to provide medical insurance cover for employees are chargeable on the employees under Schedule E. However, relief may be claimed by the employee who will in practice be treated as having paid the relevant premiums. The relief is given on a preceding year basis so that, apart from differences which may arise from one year to another in the level of premiums, the net effect is equivalent to the disregarding of medical insurance premiums in computing the tax liability of employees. This practice is correct under present arrangements but would require amendment if our proposal to withdraw the tax deduction for medical insurance premiums were implemented.

Permanent Health Benefit

12.36 The tax treatment of contributions under permanent health benefit schemes is described in paragraph 10.72. Where an employer pays permanent health premiums for an employee a benefit accrues to the employee which is chargeable under Schedule E. Schemes funded out of employers' contributions only would not in strictness qualify for approval by the Revenue Commissioners, under Section 8 of the Finance Act, 1979. The amount chargeable on each participating employee in respect of the fringe benefit involved is determined by apportionment of the employer's contribution to the individual employees. The notional contribution thus attributable to each employee would not of course be tax deductible in his hands. In the case of an approved scheme, if the employer were to reimburse employees for contributions paid by them, the amounts reimbursed would in strictness be chargeable as perquisites of the employees concerned but, assuming there is no breach of the 10 per cent limit involved, the contributions would be tax deductible and in effect participation would not involve employees in additional tax liability.

12.37 We have already recommended that premiums under permanent health benefit schemes should not be allowed as a deduction for income tax purposes. In these circumstances, all such premiums paid by employers on behalf of employees should be chargeable to tax in the hands of the employee.

Life Assurance

12.38 Life assurance premiums paid by an employer on behalf of an employee count as income of the employee for tax purposes. However, if an employee were to pay a life assurance premium for himself, he would qualify for the relief outlined in paragraph 11.65. In consequence, it is provided that where the premium is paid by the employer in such circumstances the benefit is chargeable as income of the employee. Life assurance relief is then given to the employee as if the premium had been paid by him under a contract between him and the insurer. In practice, charges in respect of benefits from the payment of life assurance premiums do not arise in all cases. This is because in many cases the provision of life cover is linked

with an approved retirement benefits scheme. Such a scheme involving the payment of a lump sum in the event of death in service will be eligible for approval if the lump sums provided for any widow, children, dependants or personal representatives of an employee who dies before retirement do not exceed, in the aggregate, four times the employee's final remuneration. Premiums paid by an employer under an approved retirement benefits scheme are not chargeable to the employees as perquisites of an employment. We do not recommend any change in these arrangements.

Free, Subsidised or Discounted Goods and Services

12.39 Free, subsidised or discounted goods and services provided to employees should be taxable as benefits. When the good or service is of a kind sold by the employer, the value of the benefit should be based on the market value of the good or service. In all other cases, the value of the benefit should be the full cost to the employer. We recognise that in some cases it may not be easy to determine the market value of the good or service. In many instances the wholesale price would be a reasonable guide.

12.40 Among the goods and services which are frequently provided to employees at free or subsidised cost are

(i) meals;

(ii) direct cost of schooling for the children of employees;

(iii) educational expenses of an employee;

(iv) free medical services;

(v) free or subsidised transport facilities;

(vi) recreational facilities including swimming pools, yachts and gymnasia;

(vii) club subscriptions, and

(viii) free car-parking facilities.

Provision of Meals

12.41 The provision of food to employees is a fairly common benefit applying to all income levels whether through luncheon vouchers or subsidised meals in staff canteens. Meals in employers' canteens are free of tax and this provision applies to directors, etc. so long as the facilities provided are substantially the same as for all employees. Luncheon vouchers are regarded (extra statutorily) as not being taxable if certain conditions are met. The conditions are

(i) the vouchers must be non-transferable;

(ii) they must be used for meals only;

(iii) if any restriction is placed on their issue to employees, they must be available to lower paid staff, and

(iv) the value of the vouchers issued to an employee may not exceed 15p for each working day.

12.42 In principle, the benefit arising from the provision of meals to employees at subsidised cost should be chargeable to tax. However, to attempt to charge this benefit would give rise to considerable administrative difficulty. For this reason, we recommend no change in existing arrangements.

Educational Expenses

12.43 Where an employer meets expenses related to an employee's children's education there is a chargeable benefit under existing legislation. However, the legislation does not cover the benefit arising from preferential university fees charged in respect of children of full-time university staff. This benefit should be chargeable on the basis of its value to the employee.

12.44 Where an employer meets expenses related to an employee's education, for example, in a trade or professional course, so that an employer's interest is being served, no benefit arises. This is also the case with in-house training. Any benefit to the employee arising from such education or training should continue to be ignored for tax purposes. Where, however, a course is unrelated to the employer's business a benefit arises which should be charged to tax.

Free Medical Services

12.45 Some employers provide free medical services for their employees. Strictly speaking, this benefit is already chargeable to tax. However, in practice it has not been possible to do so. We recommend no change in existing practice.

Free or Subsidised Transport Facilities

12.46 The benefits provided by transport companies to their employees in the form of free or subsidised travel facilities do not come within the scope of existing legislation. In principle, the value of any service or facility provided for an employee should be included in income to the extent that

the fair market value of the item or its use exceeds any amount paid by the recipient for the item or its use. For example, in the case of airlines which provide their employees with personal flights for a nominal charge when space is available, a relevant factor in determining value is the airfare which would be charged to commercial passengers for a comparable flight (when account is taken of restrictions as to reservation requirements, seating priority and cabin selection). Generally, we recommend that the cheapest airfare for a comparable flight available to the general public should be considered acceptable evidence of value.

Recreational Facilities

12.47 The provision of recreational facilities for employees is not charged as a benefit under existing legislation. Due to the administrative difficulty of doing so, we recommend no change in this area.

Club Subscriptions

12.48 Sports and other club subscriptions which are paid for employees by certain employers are chargeable as a benefit-in-kind. It is known that certain employees pay subscriptions to clubs of one kind or another and, on submission to their employers of evidence of payment, are reimbursed as respects part or all of the amount of the subscriptions. This benefit is dealt with without difficulty in practice under existing arrangements.

Free Car-parking Facilities

12.49 The provision of free or reserved car-parking facilities is a valuable benefit particularly in urban areas. Because of the value of this benefit and the fact that it may be provided on a discriminatory basis, we recommend that it be charged to tax, subject to *de minimis* provisions.

Travel and Entertainment Expenses

12.50 In order to perform their duties, some employees are required by their employers to travel (as distinct from commute), to live away from home and to entertain clients. An employee required to do these things may be provided by the employer with food, drink shelter and transport or he may be reimbursed by the employer when he incurs these expenses.

12.51 We consider that there will be an element of personal benefit to the employee in the following circumstances:

(i) When the employee's personal living expenses are reduced or,

(ii) When the purpose of the trip or entertainment is to satisfy or

remunerate the employee rather than to carry out the business of the employer.

12.52 Expenses payments by employers to cover travelling and entertainment expenses incurred by employees on behalf of the business may take the form of

(i) reimbursement of actual expenditure incurred by the employee on the basis of recorded amounts:

(ii) expenses allowances calculated by reference to a fixed scale, or

(iii) round-sum expense allowances or advances for which the employee is not required to account to the employer.

As regards the payments described under (i) or (ii), unless a direction has been given by the inspector of taxes to the contrary, an employer is authorised not to treat such reimbursements as pay if they are

(i) reimbursements of expenses actually incurred by the employee in the performance of the duties of the employment, or

(ii) payments made according to a scale calculated to do no more than reimburse the actual outlay incurred by the employee such as subsistence allowances paid for absence on business journeys.

12.53 Reimbursements by way of round-sum expense allowances are treated as pay unless the employer is specifically advised by the inspector of taxes not to treat them as pay for tax purposes. Such round-sum allowances include, for example, fixed sums paid (whether weekly, monthly or yearly) to cover expenses to be met by the employee or amounts put at the disposal of the employee for which he does not have to account to the employer. Where expenses payments by the employer are treated as pay subject to PAYE, the employee will be given a deduction for any expenses incurred by him wholly, necessarily and exclusively in the performance of the duties of the employment. Effect is given to such deduction by the appropriate addition to his tax-free allowances. In practice, it can be extremely difficult in many instances to distinguish travelling expenses from entertainment expenses. For tax purposes, however, the same principles apply to each category except that it is usually more difficult to satisfy the inspector of taxes that entertainment expenses are allowable for tax purposes. The following are some of the general principles which are applied:

(i) The cost of travelling from home to business is not admissible.

(ii) Expenses necessarily incurred in travelling on business are deductible but a person who performs the duties of his employment at one particular place is not entitled to any deduction for the expense

of travelling to that place and would be chargeable in respect of any amounts of such expenses met by the employer.

(iii) If a person is required to carry out the duties at more than one place any expenses necessarily incurred in travelling between these places in carrying out his duties are allowable as deductions.

(iv) As a general rule, the amount which will be allowed for living expenses when away from home is the excess of the outlay over the estimated cost when at home. The amount disallowed is usually referred to as "home saving".

(v) As regards entertaining expenses, only such outlay as is wholly, exclusively and necessarily incurred in the performance of the duties of the employment will be allowed under the rules of Schedule E. For entertainment expenses to be admissible, the business motives must so predominate as to render any subsidiary motives of a social or personal character inconsequential. Actual business transactions must be carried out during the course of the entertaining and the outlay on the entertainment must be reasonable in amount. Where, however, no actual business transactions are carried on during the entertaining but specific business contacts are either established or maintained the outlay will be tax deductible.

12.54 We consider that these provisions are satisfactory in principle. The difficulties of administering them should not be underestimated. However, we make no recommendations for change.

Share Option Schemes

12.55 A share option scheme is one under which an employee is given the option of purchasing up to a certain number of company shares in the future, at a price fixed when the option is granted. There are no specific statutory provisions relating to share option schemes in Irish tax legislation. Following a decision in the House of Lords in 1960, the practice in Ireland is to assess the taxable benefit of a share option at its value at the time it is granted and not when it is exercised and to tax it at the earlier date.

12.56 The House of Lords decision does not govern a case where the option is not exercisable immediately on grant and in such situations the Revenue Commissioners value the benefit as the difference between fixed price and market value on the date the option is first exercisable and tax the benefit at the latter date.

12.57 We recommend that the value of share options for tax purposes should be defined as the difference between the option price of the shares to the employee and the market price at the time the option is exercised and

should be taxable at that date. This benefit should be charged to income tax.

12.58 Share purchase schemes involve no option element but are schemes by which the employee is enabled to acquire company shares. They are usually incentive schemes which enable employees to buy shares in their company on advantageous terms (e.g. at discount or on deferred payment terms), often with the aid of a cheap loan from a special employee trust. The difference between the price payable for the shares and the market value of those shares is a perquisite of the employment chargeable on the employee under Schedule E. We recommend no change in this area.

Income Limit

12.59 We received submissions that the income limit below which benefits-in-kind are not charged to tax in the case of employees be raised. This limit has remained at £1,500 since 1958. The corresponding limit in the United Kingdom is £8,500.

12.60 The existing limit is open to abuse in that the spouses of an employee may be employed at a nominal salary. The fringe benefit may then be provided to the spouse as a method of avoiding the tax charge.

12.61 In principle, we do not see any justification for a limit and we recommend that the existing limit be abolished. If employers find that the making of returns is onerous, the remedy is in their own hands, since they can cease payment in kind and substitute payments in cash.

Discounts to Shareholders

12.62 Earlier, we drew attention to the likely growth in the practice of granting discounts on a firm's products to shareholders. Such benefits are not chargeable to tax at the moment. We recommend that the legislation be extended to charge these benefits. In administering the taxation of these benefits, we consider that the *de minimis* provisions which we recommend in the case of employee benefits should also apply to shareholder benefits.

Benefit-in-kind Tax

12.63 We believe that the growth that has occurred in the provision of fringe benefits is because they are not adequately charged to tax under existing legislation. Efficiency would be better served if employees received their total remuneration in cash and then allocated it to the goods and services they most preferred. However, it is administratively impossible to tax all such benefits in the same way as equivalent payments of cash would be. To that extent market forces will tend to encourage an increase in fringe

benefits. To combat these forces, consideration could be given to a benefit-in-kind tax which we describe in the following paragraphs.

12.64 It is not unusual for several employees to enjoy simultaneously the same facility provided by an employer and for employees to share the same facility with customers and clients. To separate the element of personal benefit in employer-paid expenses and to provide flexibility where the benefit cannot be readily allocated to specific employees, employers unable or unwilling to allocate a non-cash benefit to employees (or others) could be required to pay a special tax on the unallocated benefit.

12.65 The special tax on the employer would be designed to ensure that the cost to the employer would be at least the same whether he provided an employee with taxable income or a non-cash benefit that was not taxed in the hands of the employee. This would be achieved by taxing the employer at the top marginal rate of personal tax on the pre-tax income that an employee in the highest income bracket would have to receive in order to buy the benefit with after-tax income. The special tax paid by the employer on the non-cash benefit that was not taxed in the hands of the employee should be treated as an expense to the employer for tax purposes so that the cost to the employer would be the same where the employee paid the highest rate of personal tax.

12.66 The tax we have described would apply to any benefits the value of which were not allocated to individual employees. The tax should be charged at a rate given by the following formula: [7]

$$\frac{R+E}{1-R-E}$$

where R is the single rate of personal tax (including social security tax) and E is the top marginal rate of direct expenditure tax.

12.67 We do not recommend the introduction of a benefit-in-kind tax at this stage. We have merely described it so that it may be introduced should the measures which we have already recommended fail to deal adequately with the taxation of fringe benefits.

Recommendations

12.68 We make the following recommendations for change with regard to the tax base.

1. Fringe benefits should be charged to tax on the basis of the market value of the property, services or facilities furnished by the employer, subject to exceptions in respect of working conditions and on the grounds of administrative convenience.

[7] Where both R and E are expressed on a tax-inclusive basis.

2. The Revenue Commissioners should keep the taxation arrangements applying to benefits-in-kind under review. They should concentrate on bringing the most important items into charge and apply *de minimis* provisions where benefits are small or disproportionate administrative problems arise, provided the benefits in question are available to all employees in a firm on a non-discriminatory basis.
3. The Revenue Commissioners should publish a scale of charges to be used in assessing the benefit-in-kind arising from the provision of a car by an employer which may be used for an employee's private use. This scale should take account of the factors mentioned in paragraph 12.26. Taxpayers should be afforded the right of appeal against the application of scale benefits.
4. In the case of employees who use their own cars in the course of their business and are reimbursed on the basis of a mileage allowance, any remuneration element in the reimbursement should be charged to tax on the lines proposed in paragraph 12.27.
5. The benefit arising on loans to employees at preferential rates of interest should be charged to tax. The amount of the benefit should be calculated as the difference between the amount of interest payable at the preferential rate and that payable at either commercial rates or the rate of inflation whichever is the greater.
6. The benefit arising from the occupation of living accommodation provided for an employee, which he is required by the terms of his employment to occupy for the purposes of performing his duties, should be charged to tax to the extent that it is of value to him.
7. Benefits arising from preferential university fees charged in respect of children of full-time staff should be taxable.
8. Education fees refunded by an employer for courses unrelated to the employer's business should be charged to tax.
9. Free or subsidised transport facilities should be charged to tax.
10. Free car-parking facilities provided to employees particularly in urban areas should be charged to tax subject to *de minimis* provisions.
11. Share options should be charged at the date the option is exercised and taxed at the difference between the option price and the market price at the date of option.

12. The income limit of £1,500 below which benefits-in-kind provided to employees are not charged to tax should be removed.

13. Discounts provided to shareholders should be taxed on the same basis as benefits provided for employees.

14. To discourage the proliferation of fringe benefits, a benefit-in-kind tax on benefits unallocable to individual employees should be considered.

CHAPTER 13

THE TAXATION OF CAPITAL GAINS

Introduction

13.1 In this chapter we discuss the appropriate treatment of capital gains for tax purposes. We consider that these gains, when realised, should be taxed as income. We examine the extent to which they should be adjusted to take account of inflation, to what extent deductions for losses should be permitted, how these gains should be treated on the death of a taxpayer and whether or not some forms of gains should be given preferential treatment.

13.2 We believe that the net yield which will arise from the type of tax on capital gains, which we recommend, will be low. This does not mean that it is unnecessary. On the contrary, we believe that a major reason for charging capital gains to tax is to prevent avoidance of income tax by switching income gains into a form in which they are regarded as capital gains. This is not only necessary for reasons of equity, as not all taxpayers are able to effect this kind of switch; it is also necessary for reasons of efficiency to prevent investment distortion. Furthermore, in so far as the presence of a capital gains tax deters such switches, it will serve to protect the yield of income tax. Thus, even on the narrow criterion of revenue yield, its contribution will be more than is apparent from looking at the yield of capital gains tax in isolation.

What is a Capital Gain?

13.3 A nominal capital gain arises whenever a financial or physical asset increases in price. The price of an asset is the market's view of the capitalised (discounted) sum of the expected flow of future receipts (monetary or otherwise) produced by that asset, and that sum will, in broad terms, change for three kinds of reason: firstly, because the market forces of real demand and supply change the expected flow of returns; secondly, because monetary policy or changes in saving/investment behaviour change interest rates; and thirdly, because of general inflation affecting the nominal value of everything.

13.4 Historically, the taxation of capital gains in Ireland (and in the United

Kingdom, from whence we have derived our tax system) has been complex. Some kinds of gain have always been subject to income tax. Thus, gains which form part of the normal business income of a person (e.g. a stock jobber, car dealer or anyone else whose income is derived from selling assets at a higher price than that at which they were purchased) have been treated as trading profits under Schedule D. Stock profits have also been included in the base of the normal taxation of company profits.[1]

13.5 Until 1974, the major development was in the area of case law, where the Courts ruled that tax should be charged when a gain arose as a result of a transaction "in the nature of trade", even when the transaction in question did not form part of a person's normal business. The phrase "in the nature of trade" was meant to convey the idea that if a person buys an asset with the sole purpose of subsequent sale at a higher price (i.e. without the intention of deriving an income or personal enjoyment), the gain should be taxable as a business profit.

13.6 What have never been charged to the usual income taxes are so-called "casual gains", i.e. gains which do not bear the "badges of trade" mentioned in the previous two paragraphs. Until 1974, such gains were free of any tax in Ireland; since 1974 they have been subject to capital gains tax.

Present Position in Ireland

13.7 The first steps towards the introduction of capital gains tax were taken on 28 February, 1974, when a White Paper[2] outlining proposals for a comprehensive system of capital taxation, including a capital gains tax, a wealth tax and a capital acquisitions tax was published.

13.8 The proposals on capital gains tax in the White Paper (with some modifications) were introduced into the legislation in the Capital Gains Act, 1975. This Act provided for the taxation of capital gains arising on the disposal of assets on or after 6 April, 1974. The taxable gain was normally calculated by deducting the cost of the asset from the sale proceeds. No distinction was made between short-term speculative gains and gains on assets held for a long period of time. In addition, no recognition was given to the fact that part of most increases in price was attributable to general inflation, whereas the actual selling price might reflect a real loss or gain.

13.9 In 1978, the Capital Gains Tax (Amendment) Act, 1978 was enacted. This Act recognised the inflation problem and provided in effect that only "real" gains would be taxed. Basically, it allowed the taxpayer to set off

[1]Relief in respect of certain increases in stock values was introduced in 1975.
[2]*Capital Taxation* prl. 3688.

against the sale price, the original cost adjusted in accordance with the movement in the Consumer Price Index for the relevant period. The indexed expenditure on an asset is deducted from its sale price to give the gain chargeable to capital gains tax. In addition to making allowance for inflation, the 1978 Act introduced a distinction between long-term gains and short-term gains by applying reduced rates of tax to gains arising on the disposal of assets held for more than three years. The basic rate of tax was 30 per cent and this was reduced for every three years of ownership, leading to total exemption after 21 years. This relief did not apply to all taxpayers nor to all assets. For example, gains accruing to companies and to persons neither resident nor ordinarily resident in the State and gains accruing on the disposal of development land did not qualify for it.

13.10 Proposals to change the rates of capital gains tax were announced in the budget statement on 25 March, 1982. These included the abolition of the tapering relief and an increase in the normal rate of tax to 40 per cent. New arrangements were proposed for the taxation of short-term gains. Nominal gains realised within a year of acquisition are to be charged at 60 per cent and real gains realised within two or three years of acquisition at a rate of 50 per cent. The Finance Bill, 1982 confirms these proposals. However, the annual exemption limits of £500 for single persons and £1,000 for married couples are being increased to £2,000 and £4,000 respectively.

13.11 An outline of the main provisions of the capital gains tax appears in Appendix 10.

13.12 The present capital gains tax is quite different from the present income tax. Unlike the latter it is only very slightly progressive, the first part of a taxable gain being exempt, with the remainder being taxed at a flat rate. In addition, the gain is indexed by reference to the Consumer Price Index and gains on a very wide range of assets are completely exempt from the tax.

13.13 The central question is whether capital gains should be charged to tax as income. In the next section we discuss this issue in the context of our concept of income. The subsequent sections deals with certain important, but less central, matters arising in relation to gains taxation in general and the Irish capital gains tax in particular.

Capital Gains and The Concept of Income

13.14 Our comprehensive concept of income includes capital gains. To accord special treatment to capital gains (to exempt them from taxation or to tax them more leniently or more heavily than "other income") would conflict with horizontal equity, vertical equity and efficiency.

13.15 The conflict with horizontal equity arises because capital gains provide the same command over resources (the same consumption/saving opportunities) as other income. The conflict with vertical equity arises because the probability of reaping a given capital gain increases with wealth and so, even if income tax were strictly proportional, to give tax privileges to capital gains is to give proportionately greater benefits to the wealthy. Furthermore, since capital gains are positively related to wealth, the use of progression in taxation of other income would exaggerate the vertical inequity just mentioned.

13.16 Efficiency is harmed in two senses. Firstly, portfolio choices are distorted in favour of assets, the return from which accrues primarily in the form of capital gains rather than income chargeable to income tax and it is far from obvious that this distortion increases the efficiency with which the community's savings are used. Secondly, there is an incentive to convert receipts otherwise subject to income tax to tax-favoured capital gains. This reduces the revenue efficiency of income tax. This is why those who claim that the taxation of capital gains is not worthwhile because the revenue yield is low are missing the point. The taxation of gains (whether under income tax or a separate tax) plugs a loophole in the taxation of other income and so the true yield of gains taxation includes the increased yield from the taxation of other income. If capital gains are taxed more heavily than income, converse arguments apply.

13.17 We believe that there is a strong case in principle for charging capital gains to tax on the same basis as other income.

13.18 Nonetheless, the taxation of capital gains does involve certain questions of principle which arise in a particular form in relation to capital gains. These are

(i) whether a person's ability to pay tax rises whenever an asset's value increases (the accrual principle) or only when an asset whose value has increased is disposed of (the realisation principle), and

(ii) the relevance of inflation.

Accrual v. Realisation

13.19 Our comprehensive concept of income during a period is consumption in that period plus changes in the value of wealth between the beginning and the end of that period; or, equivalently, the maximum amount of consumption which can be undertaken during that period without the value of wealth at the end falling below the value of wealth at the beginning of the period. The value of wealth may increase either because the person has spent less than his current receipts and so increased the volume of his assets or because there has been an increase in the value of assets held at the

beginning of the period. According to traditional usage, the former would be designated as saving and nobody would question that this was part of income, whereas the latter would be designated as capital gains; under our comprehensive concept of income they would be regarded as equivalent since they both have the same effect on the consumption/saving opportunities of this person.

13.20 It will be apparent from this that whether or not the asset whose value has increased is disposed of and the gain realised is irrelevant to the comprehensive concept of income. This proposition has, however, been contested on the grounds that a person realising a gain has greater consumption opportunities than someone not realising an equal gain because a gain has to be converted into a negotiable asset (usually money) before it can be used to finance consumption. But this is not relevant. Income tax is a tax on potential consumption. In principle, accrued gains are properly taxable since they are realisable and so alter potential consumption opportunities.

13.21 To restrict tax liability, therefore, to gains only when they are realised in effect allows a person to postpone tax. This opportunity is not available to those with income in other forms. Such discrimination according to the *form* rather than the *level* of income conflicts with principles of horizontal equity. Since the probability of a given capital gain is related to wealth and since wealth and "other income" are also positively related, any favoured treatment of capital gains relative to other income arising from the deferral of tax would also reduce the effective progressivity of the income tax.[3] In paragraph 13.59 we show that any advantage arising from deferral of tax is unlikely to be significant at present rates of interest.

13.22 These points are probably accepted by most commentators on taxation. Nonetheless, all tax systems known to us confine the taxation of "casual" gains to realised gains, for reasons of administrative cost. Taxation of gains on an accrual basis would require the annual valuation of assets and the high cost of this would seriously reduce the net revenue derived from the taxation of gains and would increase the incentive for the legislators to recognise a wide range of exempted assets.

13.23 The realisation basis creates severe difficulties if a progressive tax is applied to gains on assets held for a long period. The problem of "bunching" is also discussed later. Finally, it has to be accepted that a realisation basis is chosen as a compromise. Compared to an accrual basis it provides different tax treatment of capital gains than of other income and

[3] It should be noted that this paragraph refers to the advantage to the taxpayer of the realisation as opposed to the accrual basis (i.e. the advantage of tax postponement). Analogous points relating to the general question of taxing capital gains were made earlier.

so conflicts with equity and economic efficiency; its claim on our attention is its relative administrative efficiency.

13.24 Taxation of capital gains on an accrual basis could also create cash flow difficulties for taxpayers in cases in which accrued capital gains formed a high proportion of income.

13.25 While in strict theory all capital gains should be taxed on an accrual basis, we recommend, given the practical problems involved in taxing accrued gains, that the taxation of capital gains be restricted to realised gains only.

Inflation

13.26 In our consideration of the taxation of income from capital and of the problem of unlegislated increases in real tax rates, we have accepted the need for tax systems to recognise the existence of changes in the general purchasing power of money. It is noteworthy that one of the few parts of the present Irish tax system which makes this recognition is (since 1978) the capital gains tax.

13.27 The problem can be illustrated by the following example. An asset is purchased for £1,000, held for a period during which the general price level rose by 20 per cent and sold for £1,300. The gain is taxable at 50 per cent and so £150 is paid in tax, leaving the person with £1,150. But the latter is worth only £958.33 at the initial price level: the tax has removed 4.2 per cent of the person's initial wealth, i.e. this tax exceeds 100 per cent of what is properly called income.

13.28 In our view, only *real* gains should properly be treated as income, and so a nominal gain needs to be deflated by a price index before the taxable gain is arrived at. The price index which we recommend for this purpose is the Consumer Price Index. We do so for the same reasons as those which we advance when recommending its use for the indexation of other aspects of the system and these are dealt with in Chapter 20. However, However, there is one issue worth mentioning here.

13.29 A real gain is calculated by denominating the disposal and acquisition price of an asset at the same general price level, but should that level be the one ruling at acquisition or the one ruling at disposal? In the example in paragraph 13.27, the real gain at acquisition prices is £83.33 (£1,083.33 minus £1,000) and at disposal prices is £100 (£1,300 minus £1,200). The reason for evaluating the gain at disposal prices is that other incomes will be evaluated at these prices (and the tax payable in these prices). Equity of

treatment between capital gains and other incomes therefore requires the use of the prices ruling at the time of disposal. This is the principle adopted in the Capital Gains Tax (Amendment) Act, 1978 and we endorse it here.

Bunching

13.30 The realisation basis means that gains are taxable less frequently than they would be on the accrual basis: a gain accruing over several years is not taxed in annual increments as it accrues but the whole gain is taxed in the year when it is realised. This phenomenon is known as bunching and it creates problems of equity when gains taxation is not strictly proportional. These problems provide the strongest argument in equity for not subjecting capital gains to a progressive income tax and form part of the reason why we recommend a single rate of of income tax.

13.31 Suppose an asset is held for five years and its value appreciates steadily at £200 per year. Suppose also that gains are subject to a progressive tax such that the effective rate on a gain of £200 is 10 per cent and the effective rate on a gain of £1,000 is 20 per cent. On the accrual basis, the gain in question would have been taxable at £20 a year, or £100 in total.[4] On a realisation basis, no tax is paid in the first four years and £200 is paid in the fifth year. In other words, more tax is payable on the realisation than on the accrual basis. It could be argued that this extra payment is a legitimate *quid pro quo* for any benefit reaped by the taxpayer from the postponement of his liability, but this argument is weak. The extra payment is determined, for any given time-profile of accruals, by the degree of progression in the tax and not by the application to the accruals of a rate of interest which would be the only proper way of "clawing back" the benefit of postponement. Bunching is, therefore, a problem when the income tax structure is progressive.

13.32 This problem can be solved in three ways. Firstly, since it arises only when gains are subject to a progressive tax, it could be met by subjecting those gains to a special proportional tax, separate from income tax. However, this is crude and involves a substantial compromise of the principle of parity of treatment between capital gains and other income. It is crude because it fails to recognise that the seriousness of the bunching problem depends upon the length of the holding period and, especially, that bunching is no problem at all when the holding period is a year or less.

13.33 The second approach is to apply diminishing rates as the holding period increases. This was introduced into the Irish capital gains tax in 1978. This can be incorporated into a comprehensive income tax which

[4] At a real rate of interest of 3 per cent, this will be equivalent to £106 at the end of the fifth year.

includes capital gains (it has existed, in various forms, for many years in the US federal income tax). This approach acquires validity only in the context of progressive taxes where bunching problems arise.

13.34 The main defects of the approach outlined in paragraph 13.33 are that the sliding-scale is arbitrary and that it applies only to capital gains and not to other forms of income where fluctuations occur. We do not favour this approach either.

13.35 The third approach is to charge income tax at a single rate. These problems do not then arise. Under our proposals for a direct expenditure tax it would be possible to charge realised capital gains at the same rate as income and we recommend that this be done.

The Treatment of Losses

13.36 In principle, losses are simply negative gains which can be treated symmetrically with positive gains. If, under a comprehensive income tax, gains are added to other income, then losses should be subtracted from income. If other income is insufficient — or if capital gains are subject to a different tax from other income — then net losses cause the tax base to be negative, something which is already familiar in corporate income taxes and which can be dealt with in a similar way through carryover provisions.

13.37 However, objections have been raised to full loss-offsets, i.e. to allowing net capital losses to be deducted from other income under a general income tax which covers capital gains. A person with a large amount of wealth could easily find himself in any year with a net capital loss as large as his other income. Under the comprehensive definition he would then have no income for that year. The Meade Committee[5] actually used this kind of example as an implicit argument against a comprehensive income tax base, but it is an invalid argument. Such a person has gained no command over resources during the year and the fact that the numbers in the calculation are several thousand times the equivalent number for the average person is irrelevant ($x-x = 0$ for any value of x). Such a person is better off than someone on the dole because he has more wealth, not more income, and such an example illustrates an argument not for treating capital losses unfavourably, but for supplementing a comprehensive income tax base with some form of capital taxation.

13.38 But there is an allied objection to full loss-offsets. Given high marginal rates of tax on other incomes, such offsets provide a substantial incentive for the wealthy to act as follows. Whenever an asset (say, a block of shares) declines in value, a person simply sells them and then immediately

[5] *The Structure and Reform of Direct Taxation*, 1978, pages 31 and 129.

buys them back at the same price. He ends up with exactly the same assets but has recorded a realised loss at no expense other than a small amount in brokers' fees and stamp duty. Of course, the starting point for future gains has been reduced by this procedure, but this matters only when he eventually disposes of the asset. A person with a sufficiently diverse portfolio can use these losses to postpone liability until he dies. This is a major reason why, for example, in the United States the extent to which one may offset net capital losses against other income is severely limited.[6]

13.39 On the other hand, limits on loss-offsets impose harsher burdens on less wealthy individuals who are likely to hold a narrower range of assets assets and so, if they need to realise an asset, have a greater probability of having to realise a loss and are less likely to have also an asset on which they can realise a gain against which they can offset this loss. So, if they cannot offset this loss against other income, they obtain no tax-compensation for that loss. A person with a wider portfolio is less in need of permission to offset a net loss against other income because he is less likely to have a net loss.

13.40 Equity, both horizontal and vertical, requires losses to be treated symmetrically with gains under a comprehensive tax base. The only argument of any force against that position is that full loss-offsets offer an incentive to realise losses as a tax-postponement device. It may be noted that the Irish capital gains tax does contain provisions designed to limit the allowability of such losses[7]: where a loss accrues to a person on the disposal of shares and he re-acquires shares of the same class within four weeks of the disposal, that loss shall only be allowed against any gain accruing to him on the shares re-acquired. The Revenue Commissioners have informed us that there is no evidence that these provisions are inadequate but they will keep the position under review.

13.41 Finally, it is worth noting that the indexation provisions of the 1978 Act in Ireland do not permit indexation to turn a nominal gain into a real loss (as would happen if the asset had appreciated more slowly than the general rate of inflation). This restriction is subject to the same criticisms as is limitation of loss-offsets under a comprehensive tax base.

13.42 We recommend that real losses should be fully offset against all income, subject to the anti-avoidance provisions noted in paragraph 13.40.

[6] Historically what was more important in the US was the fact that offsets had a devastating effect on the yield of the federal income tax in the depression years 1930-32 see A. R. Ilersic, *The Taxation of Capital Gains*, London, 1962 pp. 74ff. Economically this is not a respectable reason for limiting offsets since declining tax yields during depressions are exactly what a stabilisation policy requires. Limiting offsets reduces the automatic stabilising properties inherent in income tax.

[7] Paragraph 14 of Schedule 1 of the Capital Gains Tax Act, 1975.

Under our proposals in paragraph 13.46 to treat death as a disposal for capital gains tax purposes, this requires that unrealised losses on death should be set against other income. If this is insufficient in the year of death the losses should be set against the income of earlier years.

The Definition of Disposal

13.43 The question arises whether every change of ownership should count as a disposal and thus an occasion on which capital gains tax may be charged. The major methods by which ownership of an asset is given up are by sale, by gift, by exchange, by settlement on trustees and by dying. Every criterion of a good tax system requires that all of these be treated as an occasion of disposal. At present, under the Irish capital gains tax legislation, all of the above mentioned occasions are treated as disposals except for death.

13.44 Under the 1975 Act, change of ownership by bequest was treated as if there had been no change in ownership. The bequest was not treated as a disposal, but the inheritance was treated as an acquisition; the acquisition price being the value of the asset when it was acquired by the deceased. Under the 1978 Act, the acquisition price is the value of the asset at the time of death of the deceased.

13.45 Neither of these procedures is easy to justify. Failure to treat death as a disposal breaks the important lifetime equality of accrual and realisation and makes possible an avoidance device whereby an asset may appreciate significantly over several changes of ownership but will attract no capital gains tax liability if it changes hands only on death. The 1975 Act was defective in these respects; the 1978 Act is worse.

13.46 Certain aspects of capital acquisitions tax show up other defects of this aspect of the capital gains tax. The former contains provisions designed to encourage owners of wealth to dispose of that wealth before they die. But the capital gains tax provisions have the opposite effect since a chargeable gain can arise when the disposal is in the form of a gift but not when it is in the form of a bequest. We recommend that this anomaly be rectified and that death be treated as a disposal for capital gains tax purposes.

13.47 It may be held that to treat death as a disposal for capital gains tax purposes and to charge the remaining assets to inheritance tax in the hands of the recipient constitutes double taxation. We do not accept that this concept of double taxation has any validity. Under our proposals, and indeed under existing legislation, capital assets are financed by savings out of income which have borne tax. Unrealised increases in the real value of capital assets on death must be regarded as income of the deceased in the

same way as other receipts. To exempt these increases on death would be to accord favourable treatment to these gains and would discourage persons from disposing of their assets during their lifetimes. In any event, capital gains tax paid on death will be deducted from the value of any assets for gifts and inheritance tax purposes.

13.48 We consider also that, in principle, emigration should constitute deemed realisation of assets for purposes of capital gains tax. Emigration might, perhaps, be defined as a change in status from resident to not ordinarily resident. The value of the asset for tax purposes could be the value on some arbitrary date in the income tax year during which the change in status occurred. The beginning of the income tax year (6 April) would appear to be the most appropriate date.

13.49 The Revenue Commissioners advised us that

> "emigration could hardly be defined satisfactorily so as to preclude argument about whether a departure from the State was merely for a temporary purpose. Questions as to domicile would also raise major definitional and practical problems. Tax collection in cases of dispute would probably present insuperable problems. An individual's departure could hardly be prevented because of a potential tax liability".

We recognise these difficulties. However, we recommend that further consideration be given to solutions that would allow emigration to constitute deemed realisation of assets for capital gains tax purposes.

Coverage of Capital Gains Tax

13.50 Our basic position is that all realised capital gains, irrespective of source, should be subject to tax. We would require strong justification to persuade us to depart from this principle.

13.51 The range of assets on which gains are exempt from the present capital gains tax is very large (see Appendix 10). The equity and the efficiency effects of these exemptions are not essentially different from the implications of analogous exemptions in other parts of the system of personal taxation. We believe that exemptions are undesirable for the following reasons:

(i) To favour gains from particular types of assets, just as to favour particular types of other income, is contrary to equity.

(ii) It is likely that these exemptions (and similar exemptions or reliefs under income tax and capital acquisitions tax) may fail completely to achieve any of the objectives which motivated the legislators, because the tax benefits are capitalised.

(iii) The favourable treatment of gains arising from particular assets leads to waste since it distorts the pattern of investment.

Other Issues

13.52 In the following paragraphs we consider a number of specific issues which arise in relation to the present capital gains tax in Ireland:

(i) The exemption of small gains;

(ii) The exemption of Government securities;

(iii) The exemption of personal chattels of a durable nature;

(iv) The exemption of a principal private residence;

(v) The deferral of tax on certain realised gains, and

(vi) The taxation of capital gains realised by companies.

Small Gains

13.53 At present, the first £500 of chargeable gains of an individual in any year of assessment is exempt from taxation. For married couples living together, the exemption limit is £1,000. The Finance Bill, 1982 proposes to increase these exemptions to £2,000 and £4,000 respectively. These gains are in real rather than nominal terms. In principle, we see no reason for any exemption limit since income in the form of real capital gains confers the same command over economic resources as other income. We recommend that all such capital gains be charged to tax.

Government Securities

13.54 We recommend that Government securities be regarded as chargeable assets for capital gains tax purposes. In many cases this provision will benefit taxpayers who have incurred substantial real losses on holdings of Government securities while being charged to tax on the full interest receivable, even though this may not have even compensated them for inflation. We consider that this is essential in order to achieve horizontal equity and provides a strong case for allowing real capital losses against other income. Despite the fact that this change would generally benefit holders of Government securities, any change may have to be limited to new Government securities because of limitations in the prospectuses of existing ones.

Personal Chattels

13.55 A gain accruing to an individual on the disposal of an asset which is tangible moveable property and not a wasting asset, where the consideration does not exceed £2,000, is not a chargeable gain. Where the consideration is slightly in excess of £2,000 there is marginal relief. Gains or losses on the disposal of wasting assets, i.e. assets with a predictable life not exceeding fifty years, which are tangible moveable property are also disregarded. This exemption does not apply to assets which have been exclusively used for the purpose of a trade or profession or could have qualified for capital allowances.

13.56 We recommend no change in respect of personal chattels. It does not seem desirable or practicable to us for changes in the value of personal goods to be brought into the tax base. Gardening tools, pots and pans, cutlery and crockery, ordinary domestic furniture, private motor cars etc., are even more in the nature of personal consumption expenditure, from which gains giving rise to inequities are not likely to arise. In fact, if gains and losses on such items were brought into the base, the losses would predominate and the result would be, in effect, an inadvertent tax subsidy for personal and domestic expenses.

Private Residence

13.57 At present, a gain which accrues to an individual on the disposal of an interest in a private residence and grounds of up to one acre which has been occupied by him throughout the period of ownership as his only or main residence is exempt from capital gains tax. The relief was extended in respect of disposals of a dwelling made on or after 6 April, 1979 which, during the period of ownership, was the sole residence, rent free, of a dependent relative.

13.58 We consider that the total exemption of real gains on a principal private residence from tax further enhances the attractiveness of holding assets in the form of houses and leads to a waste of resources. In addition, if the exemption is capitalised in the price of houses, its existence has raised the price of houses, making it more difficult for people to acquire their own homes. In this case, the only people who benefit from the exemption are auctioneers, solicitors and others professionally involved in buying and selling houses, the builders of new houses, and persons owning houses when the exemption was introduced who sell and emigrate to a country which offers no such concession. We recommend that the exemption be withdrawn. In our view, when real gains are realised on a house and not used to purchase another house there is no case for not taxing them.

Deferral of Tax

13.59 One of the major problems with a capital gains tax levied only on realised gains is that this has a locking-in effect, in the sense that there is an

incentive to postpone the realisation of an asset carrying a capital gain, even if otherwise there might be some increase in yield to be obtained by selling the asset in order to invest the capital in a more productive line. To overcome this problem, the existing legislation contains provisions which allow liability to be deferred if the proceeds of sale are reinvested in similar assets within prescribed time limits. This problem is obviously less acute when tax is levied only on real gains as opposed to a system which charges gains in money terms, since the liability is likely to be less and real losses may be present in many cases. The Meade Report outlined a complex formula[8] to allow for the benefit of deferral of tax on unrealised gains, which would remove the lock-in effect of taxing realised gains. We consider that this formula, while theoretically correct, is too complicated to be put into operation. However, the Meade formula does show that there is no benefit from deferral and consequently no lock-in effect when real post-tax rates of interest are negative.

Roll-over Relief

13.60 When capital gains are charged to tax on realisation, the question arises whether or not the tax on these gains should be deferred if the proceeds of sale are re-invested in other assets. The advantage of such a relief is that it might encourage the reinvestment of realised capital gains. The relief is also a serious violation of equity principles. The effect of roll-over relief is that those who accumulate savings from realised but reinvested capital gains have the tax on those savings deferred, while those who save from other income must pay full rates of tax at the time the income is received. It is difficult to find any reason to support a system which enables some asset-holders to save out of tax-free income, while others must save out of taxed income. If such a substantial incentive to investment and saving is required, there are alternative methods of providing it, without discriminating among any of the sources of savings. We consider that our general recommendations will result in a substantial shift in the bias of the tax system away from borrowing and in favour of saving.

13.61 One further point remains to be made on the question of roll-over

[8] *The Structure and Reform of Direct Taxation*, Institute of Fiscal Studies, 1978, Appendix 7.1. The formula is $(S-C_2) \log \frac{S}{C_1} \Big/ \log \frac{S}{C_2}$

where S is the amount for which the asset is sold, C_1 is the acquisition cost of the asset multiplied by the inflation factor between the time of acquisition and realisation and C_2 is the acquisition cost multiplied by the corresponding interest factor. On the basis of this formula, the report concludes that provided capital gains were indexed and charged to full income tax rates, the need to allow for deferral would arise only when real interest rates were significantly different from zero.

relief. We can readily appreciate the need for such relief in cases in which capital gains tax is levied on nominal capital gains with no allowance for inflation. In such cases, there is a substantial capital levy on realisation of gains which, unless deferred, would severely hit investment. Once capital gains tax is charged on real gains only, the argument radically changes. In these circumstances, roughly half the cases will have real capital losses which the holder will not wish to defer but will wish to set against his other income whether in the form of realised capital gains or not. We can see little reason why the credit for losses should be deferred. To allow tax on gains to be deferred while immediate credit was given for losses would be difficult to justify. On this basis, we cannot recommend that roll-over relief be generally provided.

Replacement of Business Assets

13.62 Under existing legislation, there is provision for deferral of other capital gains tax liability arising on the disposal of certain business assets where the proceeds are re-invested in business assets. Where part of the proceeds are re-invested there are apportionment rules. For the relief to apply, both the asset sold and the asset acquired must fall within one (but not necessarily the same one) of the following categories:

(i) Land and buildings occupied and used solely for the purpose of the trade.

(ii) Plant and machinery used solely for trade purposes.

(iii) Goodwill of a trade.

The investment in replacement assets must take place within a four year period, commencing one year before and ending three years after the date of the disposal.

13.63 We received a number of submissions which proposed extensions to this relief. These included:

(i) The qualifying assets for re-investment purposes should be extended to include land improvement, e.g. reclamation and fencing.

(ii) Where a second disposal of land does not give rise to a capital gains tax charge, e.g. when a farmer dies or transfers his land to his children on retirement, any liability arising on an earlier disposal of the same land should be waived or paid only on a subsequent disposal by the relative.

(iii) Relief should be available to a company which carries on two or more separate trades.

(iv) The relief is cumbersome and keeps alive, for the whole existence of a business, the gains made on earlier disposals.

13.64 These submissions highlight the scope that exists for eroding the tax base by making reasonable cases for the extension of existing concessions. In coming to a view on this issue, we have noted a point in one submission which stated that "with indexation on top of the roll-over relief, few assets produce a taxable gain". In a situation in which the charge to capital gains tax is confined to gains in real terms, we do not think an indefinite deferral of tax on realised gains is appropriate. In cases in which there are real losses, taxpayers will wish to set these against their other income. We believe this is correct. Where there are real gains, we consider that the only concession which should be available is to allow taxpayers to pay the liability over a number of years subject to payment of interest. Since we believe that, with indexation, the relief in its existing form is unjustified, we do not have to concern ourselves with the arguments which have been put forward for its extension.

Compulsory Purchase

13.65 Where certain assets situated in the State are disposed of under a compulsory purchase order and the proceeds are reinvested in assets within the same class as the original assets, no capital gains tax is payable on the disposal, but the whole gain is assessed when the replacement assets are disposed of. In line with our position on roll-over relief, we consider that this concession should be terminated. Any liability arising could be spread over a number of years subject to payment of interest.

Disposal of a Business or Farm

13.66 A gain arising to an individual, who has attained the age of 55 years, on the disposal of a business, farm or shares in a family company is disregarded where the consideration is less than £50,000. Where the gain is slightly in excess of £50,000 there is marginal relief. To qualify for the exemption, the individual must have owned the assets for a minimum period of ten years ending with the disposal. Where shares in a family company are being disposed of, the individual must have been a full-time working director for the same minimum period.

13.67 Where the assets are disposed of to a child, no capital gains tax is payable irrespective of the consideration. Disposals to nephews and nieces who have worked in the business substantially on a full-time basis also come within the scope of the concession. These provisions result in a very large gap in the existing capital gains tax.

13.68 The case for these concessions rests on the need to encourage on

economic grounds earlier transfer of property to children. The need for such concessions is apparent when regard is had to the present favourable treatment of assets passing on death. We have already recommended changes in the treatment of assets passing on death which would ensure that the liability on gains on such assets would be satisfied on death. On this basis, matching concessions on assets transferred during life are unnecessary. We recommend that the existing arrangements be terminated. We would, however, be prepared to extend the facility of payment by instalment subject to interest charges.

Owner-occupied Housing

13.69 We have recommended that the existing exemption for a principal private residence for capital gains tax purposes be repealed. This raises the issue of whether or not some deferral of capital gains tax liability should be provided for when the proceeds of sale are used to buy another house.

13.70 To charge tax on gains realised on the sale of houses may create rigidities in the housing market. This may have adverse economic effects by making people reluctant to seek employment in other areas. However, the effect of capital gains tax in this area may be exaggerated. Owner-occupation tends to reduce the mobility of labour since the direct costs of moving house are substantial. Both buying and selling a house involve legal and other expenses which, if not obligatory, are generally held to be advisable.

13.71 The magnitude of the costs of moving house in 1981 is illustrated in Table 19.

TABLE 19

Typical Costs of Moving House 1981

		£
A.	Selling Costs (House price £40,000)	
	Legal costs @ 1½ per cent	600
	Auctioneers fees @ 2½ per cent plus expenses	1,000
	Redemption of mortgage, say	100
B.	Buying Costs (used house, price £40,000)	
	Legal costs @ 2½ per cent	1,000
	Stamp duty @ 4 per cent	1,600
	Survey	100
C.	Physical Moving Costs	300
		4,700

13.72 We do not think that the universal allowance of roll-over relief in

respect of housing can be justified. We asked the Revenue Commissioners if it would be possible to confine roll-over relief to gains arising on the sale of a residence to persons who are required to move house for the purposes of obtaining employment. They replied that

> "any attempt to import conditions for roll-over relief designed to cover all deserving cases would be likely to encounter problems of definition, interpretation and administration".

13.73 It may be helpful to examine the implications of charging gains on a principal private residence to tax, based on the movements in prices in recent years. A house sold for £40,000 in the third quarter of 1981 could have been bought for £10,600 in 1974.[1] The capital gains tax liability would be as follows:

	£
Sale price	40,000
Indexed cost £10,600 x 2.812	29,807
Gain	10,193 at say 25%
Tax due	2,548

13.74 In view of the substantial costs of moving house, it may be felt desirable to make some concession in this area. We would prefer if this concession were made by reducing stamp duties rather than by granting an exemption or relief for capital gains tax purposes. At the very least, stamp duties payable should be credited against any liability to capital gains tax. On this basis, we recommend that deferral of capital gains tax liability on the sale of a house should not be provided for. Consideration could also be given to giving an allowance for transactions costs involved in buying and selling houses against the sale price of a principal private residence if further relief were thought to be called for. However, all reliefs in this area are likely to increase the price of housing.

Companies and Capital Gains Tax

13.75 There are a number of unsatisfactory features of capital gains tax as it applies to companies. Firstly, prior to 1982, different rates of capital gains tax applied to gains realised by individuals and companies. Under our proposals, there would be a single rate of capital gains tax. However, it is important to make the point of principle that gains realised through the medium of companies should not be treated differently from other gains. Secondly, on the liquidation of a company a double exposure to capital

[1] Based on movements in prices of new private houses. Table 19 of Quarterly Bulletin of Housing Statistics. Department of Environment.

gains tax may arise on the realisation of the assets of the company and on the redemption of the shares of the company by its shareholders. We regard this as double taxation in the same way as occurs with income under the classical system of company taxation. Under our proposals, income and realised gains would be charged to tax as income. We recommend that realised gains which have borne tax should carry a tax credit when they are distributed in the same way as other income.

Conclusion

13.76 This chapter highlights some of the deficiencies in the existing capital gains tax legislation in Ireland. Our conclusions flow inevitably from the comprehensive tax base which we have adopted. To achieve equity and neutrality it is essential that gains realised in the form of capital gains should attract the same tax treatment as other income. Under our proposals to levy tax at a single rate, this causes no difficulty.

Recommendations

13.77 We make the following recommendations:

1. Capital gains should be charged to tax on realisations rather than accruals.
2. In computing the amount of any capital gain or loss, the acquisition cost of an asset should continue to be adjusted by the change in the Consumer Price Index in the period between acquisition and disposal.
3. When tax is charged at a single rate, income arising in the form of realised capital gains should be charged to tax as income.
4. Capital losses should be allowable against other income, subject to the anti-avoidance provisions noted in paragraph 13.40.
5. Death should be treated as a disposal of assets for capital gains tax purposes.
6. In principle, emigration should constitute deemed realisation of assets for capital gains tax purposes.
7. The exemption limit for small gains should be abolished.
8. All Government and other securities should be chargeable assets for capital gains tax purposes.
9. No change is required in the treatment of personal chattels for tax purposes.
10. The exemption of a principal private residence for capital gains tax purposes should be withdrawn.

11. Provisions allowing for the deferral of capital gains tax liability where the proceeds on realisation are reinvested in other assets should be replaced by arrangements for payment of tax due by instalments (subject to interest charges).

12. The existing provisions allowing relief and exemptions to persons aged 55 years or over who dispose of business assets should be terminated.

13. Stamp duty payable on the acquisition of a house should be allowed as a credit against any capital gains tax liability on the disposal of a previous residence.

14. Consideration should be given to giving a deduction for transactions costs involved in buying and selling houses against the sale price of a principal private residence in computing liability to capital gains tax.

15. Capital gains realised by companies should be charged to tax at the same rate as other income.

16. Capital gains realised by companies which are charged to tax should carry a tax credit when they are distributed in the same way as other income.

CHAPTER 14

THE TAXATION OF DEVELOPMENT GAINS

Introduction

14.1 In this chapter we consider the appropriate treatment for tax purposes of gains from development land. These gains arise in part from decisions by the community. We conclude that, in principle, where a gain stems from community action or decision, the benefit should accrue to the community.

14.2 There are a number of methods of securing this benefit for the community. In addition to special taxation arrangements, these include the making of charges for planning permissions or for the provision of infrastructural services and the acquisition by public authorities of development land at its value at existing use. These other methods are outside our terms of reference. We have confined ourselves to examining whether or not it is possible to apply special taxation arrangements to development gains. We have concluded that this could be done, but whether or not it is the best way of dealing with development gains is a question we leave open.

Betterment

14.3 We received submissions which argued that special taxation arrangements should apply to gains from development land. Real gains in the value of land may arise from the following factors. Firstly, land may increase (or decrease) in value as a result of actions by the community such as the provision of roads and sanitary services. Secondly, land may increase in value as a result of decisions by the community to allow development to take place or as a result of speculation that such decisions will be made in the future. The increase in value may also accrue to neighbouring land as well as to the land which is to be developed.

14.4 The increase in the value of land due to these factors is often known as betterment. Because gains from betterment arise from community action or potential actions rather than the efforts of the landowner or the inputs of the developer, it follows that the benefit of these gains should go to the community. We conclude that in principle, where a gain stems from community action or decision, the benefit should accrue to the community.

Background

14.5 A lengthy examination of the question of gains from development land was conducted by a Committee[1] chaired by Mr. Justice Kenny which was established by the Minister for Local Government in January, 1971 with the following terms of reference:

"(i) To consider, in the interests of the common good, possible measures for

(a) controlling the price of land required for housing and other forms of development;

(b) ensuring that all or a substantial part of the increase in the value of land attributable to the decisions and operations of public authorities (including, in particular, decisions and operations relating to the provision of sewerage and water schemes by local authorities) shall be secured for the benefit of the community;

(ii) To report on the merits and demerits of any measures considered, with particular reference to their legal and administrative practicability,

(iii) To advise on what changes in the present law may be required to give effect to any measures recommended".

14.6 The recommendation of the majority report of that committee in respect of "designated"[2] areas was as follows:

"We think that the community is entitled to the whole of the increase in price in undeveloped land which is attributable to works carried out by local authorities. The amount of this increase can however never be precisely quantified. It is possible to prove that an increase in price of undeveloped land has or will occur as a result of works undertaken by a local authority; it is not possible to isolate the amount of the increase caused by them. If therefore the principle that the community has a valid claim to the whole of the increase in price in undeveloped land which is attributable to works carried out by a local authority is accepted, the only way in which this can be made effective is by giving local authorities the right to acquire at existing use value all the

[1] *Report to the Minister for Local Government by the Committee on the Price of Building Land* (Prl. 3632), March, 1973.

[2] The definition of a "designated area" proposed in the majority report was
"an area which in the opinion of the High Court is one: (a) in which the lands will probably be used during the following ten years for the purpose of providing sites for houses or factories or for the purpose of expansion or development, and (b) in which the land or substantial part of it has been or will probably be increased in market price by works carried out by a local authority which were commenced not earlier than the first day of August, 1962, or which are to be carried out by such local authority". (para. 116).

undeveloped land which will be increased in price by the works which they carry out. As the price of such land has been increased in part by general economic influences which are not included in the concept of betterment, the owners of it have a valid claim to something more than existing use value. We recommend that they should be given 25 per cent of the existing use value as an addition. Payment to landowners of existing use value at the date of acquisition plus 25 per cent of it is in our opinion a reasonable compromise between the rights of the community and those of the landowners".

14.7 The minority report took an opposing view. It felt that the local planning authority should have a right of pre-emption where a designated area order was in force. Where such an order was in force in respect of any land it would not be lawful for the owner of such land to dispose of any interest in the land unless the interest had first been offered to the planning authority for the area. There would be a levy (of 30 per cent) on disposal or development by a vendor or developer of any land in an area in respect of which a designated order was in force. This scheme was called the pre-emption and levy scheme.

14.8 Neither the proposals of the majority or minority reports have so far been implemented. The treatment of development gains in certain other countries is set out in Appendix 11

Present Position

14.9 The present position regarding development gains is as follows. A profit on the disposal or part disposal of a property is taxable as income if the disposal or part disposal is made in the course of a trade or deemed trade. Otherwise capital gains tax is charged on the disposal of development land. Development land is defined in the Capital Gains Tax (Amendment) Act, 1978 as

"land in the State the consideration for the disposal of which exceeds what the market value of the land would be if, immediately before the disposal, it had become unlawful to carry out any development . . . . in relation to the land . . . ."

14.10 Development gains are already subject to special capital gains tax arrangements. The Capital Gains Tax (Amendment) Act, 1978 provided that gains arising on the disposal of development land were to be charged at a rate of 30 per cent. They did not qualify for tapering relief. Proposals to change these arrangements were announced in the budget statement on 25 March, 1982[3]. These included an increase in the rate of tax on develop-

[3] The Finance Bill, 1982 includes legislation to give effect to these proposals. However, it is proposed that where the total consideration received by an individual for disposals of development land does not exceed £15,000 in any year of assessment, the gains on the disposals will be taxed as if they were gains or disposals of ordinary land. Full indexation relief and roll-over relief will apply in these cases.

ment gains to 50 per cent, except in compulsory acquisition cases where the proposed rate is 40 per cent. Indexation relief will only be allowed in respect of the then existing use value on the date on which the gain is computed. Roll-over relief will not apply and losses on other disposals will not be allowed against development land gains. The proposed rates of tax for short-term gains outlined in paragraph 13.10 will apply to all disposals of development land within three years of acquisition.

14.11 Developers are already obliged in most cases to provide, or pay for local roads, drains and sewers within areas under development. In addition, they may sometimes by agreement with local authorities meet other costs, such as those of certain roads needed to give access to sites, trunk sewers and extensions to sewage disposal works. Occasionally, they may agree to provide free land for municipal purposes or even to provide such facilities as a community centre or library.

14.12 The more usual type of case, however, is that a local authority provides general facilities for development. For example, the provision of a new sewer in one district can relieve the general sewerage system and so enable it to serve new development in another area. To deal with such cases, certain local authorities have adopted the practice of imposing a condition on a planning permission requiring a flat level of contribution. In County Dublin, the contribution for residential development is £4,000 an acre at present. Charges made by other local authorities are generally lower than this.

The Issues

14.13 In considering the taxation of development gains, a number of issues require to be settled. These are

(i) whether or not special taxation arrangements should apply to development gains;

(ii) if so, the rate of tax;

(iii) the definition of disposal for the purposes of the tax, and

(iv) identification of development gains.

Taxation of Development Gains

14.14 The object of all proposals for levies or special taxation of development gains is to secure for the community the benefit of any gain resulting from community action or decision. In our view, one effective and efficient way of achieving this object would be the imposition of a development gains tax. Development gains are already identified for the

purposes of capital gains tax and the Revenue Commissioners have informed us that this arrangement works well in practice.

14.15 We are conscious that a decision to impose a high rate of tax on development gains may have the effect of limiting the amount of development land coming on the market. Alternatively, the increased price of development land as a consequence of heavy taxation might be passed on to the consumer, thus raising important questions about the incidence of tax. The available evidence does not suggest that either of these eventualities is likely to occur. The Royal Institution of Chartered Surveyors have informed us that

> "high land prices in general reflect buoyant demand, and flow from the ability of users to pay. Conversely, lower land prices reflect a reduced level of demand, and a reduced ability to pay".[4]

The Rate of Tax

14.16 If taxation is considered to be the best means of securing for the community the benefit of any gains resulting from community action or decision, then on equity grounds the full amount of betterment should be appropriated in taxation. However, if a landowner is left with no gain at all, the result may be simply to dry up the land for development. On balance, we feel that a high rate of tax should be applied to development gains if the taxation approach to this problem is adopted.

14.17 In many cases, it will be the original landowner rather than the developer who will obtain the betterment gain. However, in some cases development gains will accrue to developers. We consider that it would be appropriate to allow a deduction against development gains to developers for contributions made to infrastructural costs in the latter cases.

The Definition of Disposal

14.18 We do not think that property passing on death or by gift should be regarded as a disposal for purposes of a development gains tax. Such transfers of property would, however, be regarded as a disposal for capital gains tax purposes, its value for these purposes being at existing use. This value would then be the base value for capital gains tax or development gains tax on any subsequent disposal. The purpose of these arrangements is to ensure that development gains tax would be payable only in cases where there was a realisation of the property.

Identification of Development Gains

14.19 In principle, the correct approach would be to charge the normal rate of tax on the ordinary gain on land and a 100 per cent rate of tax on the

[4]Document sent to Commission on 15 October, 1981, para 3.3.

betterment gain. While it is relatively easy in most cases to identify disposals of land where part of the gain is a development gain, it is somewhat more difficult to apportion the total amount of the gain between that attributable to the normal increase in market value and the betterment gain. We have considered whether this might be done by the use of indices but have concluded that this would create more problems than it would solve. We consider therefore that a single rate of tax might be applied to the entire gain in any case in which development gains arise. This rate of tax would be higher than the normal rate of capital gains tax.

Conclusion

14.20 We make no recommendation about whether or not special taxation arrangements should apply to gains from development land. We have, however, reached the following conclusions:

1. Where an increase in the price of development land is attributable to community action or decision or to the anticipation of such action or decision, then, in principle, the whole of that increase should accrue to the community.
2. Taxation is but one method which could be used to ensure that this is done.
3. Gains from development land, that is, gains in excess of those at existing use value, could be charged to a special development gains tax.
4. Should it be decided to introduce a development gains tax, we recommend that the tax include the following features:
   (a) It should be levied at a high rate;
   (b) In computing the amount of development gains, a deduction should be allowed in respect of payments made to local authorities for the costs of providing infrastructure, and
   (c) Disposals for purposes of development gains tax should only be regarded as occurring where the property was transferred by way of sale.

CHAPTER 15

THE UNIT OF PERSONAL TAXATION

Introduction

15.1 In this chapter we examine the question of the appropriate unit of personal taxation, that is, the unit over which income is aggregated for tax purposes. No solution to this issue succeeds in satisfying all the criteria which should be met by the ideal unit. We conclude that the family is the most suitable unit for purposes of taxation in Ireland, subject to certain provisions being made in compliance with the requirements of the Constitution. We recommend that the income accruing to children under the age of sixteen years be taxed as income of the family unit, subject to *de minimis* provisions. We recommend different criteria in Chapter 16 for payment of child benefit.

Present System

15.2 Prior to 1980/81, the income of a husband and wife living together was aggregated for income tax purposes and the liability was computed on the basis of the joint income of both spouses. All other persons were charged to tax on the individual basis. On 25 January, 1980 the Supreme Court decided that certain sections of the Income Tax Act, 1967, which had the effect that, on marriage, the wife's income was aggregated with of her husband for the purposes of assessment to income tax, were repugnant to the Constitution in so far as they related to the aggregation of the earned incomes of husband and wife.[1]

15.3 Following the judgement in the Murphy case, families with the same joint incomes would have been liable for widely differing amounts of tax, depending on the distribution of the income between the spouses. In those cases in which the income was divided equally, the burden would have been least. Considerable scope for tax avoidance would have existed for

[1] *Francis and Mary Murphy v Attorney General.* The judgement stated that the decision was made because "the nature and potentially progressive extent of the burden created" by the aggregation of the incomes of married persons was such that it was a breach of the pledge by the State to guard with special care the institution of marriage and to protect it against attack.

persons who would have been able to determine the distribution of income between the spouses.

15.4 The Government's response to the Supreme Court decision was to implement income-splitting for married couples from 1980/81. Under this system, the tax liability of a married couple opting for aggregation is generally equivalent to twice the amount payable by a single person with half the joint income. This means that the tax liability of virtually all married persons is at worst the same and in most cases is less than it would be if they opted to be charged as single persons.

15.5 Since 1980/81, married couples have three choices as to how they are assessed to income tax:

(i) *Joint assessment*, because it is generally beneficial, is applied automatically unless either spouse gives notice of election for single assessment to the Revenue Commissioners before the end of the tax year. Such notice, when given, continues in force until withdrawn by the spouse who gave notice.

(ii) Where a wife is living with her husband and an election for *single assessment* is made, each spouse is taxed as a single person with no right of transferring allowances or reliefs between them.

(iii) Where the incomes of a married couple are jointly assessed they may elect for *separate assessment*, resulting in the tax payable under joint assessment being allocated between the spouses in accordance with apportionment rules.

15.6 Different units are used for other direct taxes (e.g. the individual is used for capital acquisitions tax). In principle, the same unit should be used for all.

15.7 The choice of the appropriate tax unit must be made in the light of a number of conflicting considerations. The most important of these are as follows:

(i) Families in the same circumstances with the same joint resources should be taxed equally.

(ii) The decision to marry or not to marry should not be affected by tax considerations.

(iii) The arrangements involved should be reasonably simple for the taxpayer to understand and for the tax authorities to administer.

(iv) The system should not discriminate on grounds of sex.

15.8 The fundamental reason for not adopting the individual as the tax

unit is that incomes are shared, in practice, over much wider units and that if the tax system is to be equitable it must recognise this fact. Members of a family generally share their resources on the basis of relative need rather than according to how income happens to be divided between them. Two identical families enjoying the same total income ought not, therefore, to be taxed any differently just because in the case of one family the income accrues initially to one member and in the other it is acquired by two or more. The expenses of earning income are a separate issue dealt with in Chapter 10.

15.9 The selection of the appropriate unit of taxation is one of the most difficult issues in the field of personal taxation. The difficulty is clearly illustrated by the different conclusions reached on the subject of the tax unit by the Carter Commission in Canada in 1966 and the Asprey Committee in Australia in 1975. The Carter Commission stated:

> "We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as the marriage is contracted, it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset. In Western society, the wife's direct financial contribution to the family income through employment is frequently substantial. It is probably even more true that the newly formed family acts as a financial unit in making its expenditures".[2]

15.10 The Asprey Committee took the opposite view:

> ". . . the adoption of a compulsory family unit basis must be rejected on the grounds of general social principle. The right to be taxed as an individual has always been accorded in Australia. At a time when women are playing an ever greater role in the economic and other affairs of society, the withdrawal of this right would certainly be regarded as a retrograde step. And objections would come not only from women: men too might take exception to a universal and compulsory commingling of their tax affairs with those of their wives. This would, in the Committee's view, make a change in this direction politically unacceptable irrespective of whether married women (or married men) paid more or less tax after the change than they do now; social attitudes to the separate status of the sexes, rather than purely economic considerations, are involved here".[3]

---

[2] *Report of the Royal Commission on Taxation*, 1966. Vol . 3, page 123.
[3] *Taxation Review Committee Full Report*, 1975, page 134.

15.11 In seeking an answer to this difficult problem, consideration must be given to the laws, traditions and social conditions which exist in the country in which the system of taxation operates. In Ireland, the Constitution defines the family as the basic unit of society and lays down principles for its protection.[4] The principle of aggregation is also well established. On this basis, we believe that the proper solution in present-day circumstances in Ireland is to aggregate the income in families for tax purposes. To comply with the decision in the Murphy case, married couples would continue to have the option to be charged as single persons. This solution acknowledges both the relevance of the family in the tax code and the rights of the individual.

15.12 We consider that this approach is consistent with that adopted in the Family Home Protection Act of 1976, which represents the latest legislative thinking on the subject. In general, the Act restricts the right of the spouse, who is the legal owner of the family home, to dispose of it or certain chattels without the written consent of the other spouse.

15.13 In coming to this conclusion, we have been particularly influenced by the need to ensure that families in the same circumstances with the same joint resources should be taxed equally. We recognise that income-splitting makes no allowance for the fact that by sharing household expenses a married couple can probably live more cheaply than can two single adults who live separately. However, no decision on the unit of taxation can satisfy all criteria simultaneously. In our view, the balance of advantage is to make the family the basic unit of taxation for all taxes.

Children

15.14 It remains to be decided whether or not the income of children should be aggregated with that of their parents for tax purposes. On balance, we believe that on the basis of the income-sharing approach which we have adopted, the income of dependent children should be aggregated with that of their parents subject to *de minimis* provisions. At present, if the income of a child does not exceed £80 per year the income tax child allowance is granted in full. If the child's income exceeds £80, the income tax child allowance is reduced pound for pound by the excess. To raise this amount significantly would open the door to tax avoidance schemes and be contrary to the principle of regarding the family unit as the appropriate unit for tax purposes. Consequently, we consider that the first £150 of a child's income might be disregarded to ease administration.

[4] *Bunreacht na hEireann, The Constitution of Ireland*, Articles 41 and 42.

15.15 The adoption of a family unit for tax purposes gives rise to one special problem. Because the same unit should be used for all direct taxes, this means that gifts and inheritances received by children in the family unit from their parents would be free of tax regardless of the amount. It is therefore necessary to devise arrangements whereby such receipts attract tax when the child leaves the family unit. We make recommendations concerning this aspect of taxation in Chapter 34.

15.16 We must now examine the criteria to determine when children are to be included in the family unit for purposes of income aggregation. There is a statutory provision limiting the amount of work that can be undertaken by children under 15 years. We see little alternative to selecting a fairly arbitrary age limit below which children are included in the family unit and above which they are automatically charged to tax as single individuals, if they have income. The age limit we have in mind is sixteen years. We select a different age limit for payment of child benefit in paragraph 16.22.

Other Dependants

15.17 We have also considered whether the income of dependants other than children should be aggregated for tax purposes with other family income. This issue is related to making an allowance for support of dependent relatives. There is no doubt that aged parents are often an integral part of the family unit both in physical presence and by reason of affecting family expenditures. Furthermore, there are circumstances in which relatives do assume responsibility for a brother, sister or more distant relative. However, there are also many cases where the responsibility is nominal, partial or is not assumed at all. In these circumstances, we think that the family unit should only include spouses and children, except in cases where the additional allowance for dependants residing with the taxpayer, which we recommend in Chapter 16, is claimed.

Other Units

15.18 Couples sometimes live together as a family (often with children) who are not legally married. One or both partners may also have a legal spouse from whom they are separated *de facto* and possibly *de jure*. In principle, such couples should be treated as family units for tax purposes regardless of the legal status of their relationship. We recognise that there are considerable difficulties in this field, particularly in the case of short-term relationships.

15.19 Developments in this area must take account of the general position in relation to the development of family law in areas quite unrelated to taxation. The law in relation to taxation should not be in advance of this general development. Subject to this, we propose to leave it to the Oireach-

tas to devise whatever arrangements are considered appropriate for relationships which are akin to marriages in all but legal form. Should it be considered that some additional provisions are required, we believe that the recognition of deeds of covenant in certain circumstances would be the best method of overcoming the difficulties with regard to short-term relationships.

Conclusions

15.20 The tax unit should be defined in a way which reflects the manner in which society organises itself for social and economic purposes. It should recognise that people pool their resources and assume the responsibility for the care and maintenance of others. The tax code cannot take into account every individual case where incomes are shared or responsibility, whole or partial, assumed. It must therefore make certain assumptions and the obvious group about which to make these assumptions is the family. We therefore recommend that income-sharing be assumed to exist between spouses (except where the spouses declare otherwise) and between parents and dependent children occupying the same household. This implies that the income of spouses and dependent children be aggregated and that taxation on an individual basis be applied in other cases. Married couples would still have the option to be assessed as single persons and in such a case we recommend that the income of dependent children should be divided equally between the spouses for tax purposes.

Recommendations

15.21 We make the following recommendations:

1. A husband and wife living together should be regarded as the basic unit for all taxes.
2. Married persons should continue to have the right to be charged to tax as single persons.
3. The income in excess of £150 per annum of children under 16 years should be aggregated with the income of the family.
4. When children leave the family unit (at age 16 years), we recommend that tax be payable on whatever property they take with them from the unit subject to the arrangements proposed in Chapter 34.
5. Where married persons opt to be assessed as single persons the income of children under 16 years should be divided equally between the parents for tax purposes.

CHAPTER 16

PERSONAL TAX—ALLOWANCES AND RELIEFS

Introduction

16.1 We consider that taxes should be allocated among individuals and families in proportion to their ability to pay. In this chapter we examine the steps that are necessary to equalise the tax imposed on individuals and families which have the same income but differ in other relevant aspects. At present, an attempt is made to achieve equity by giving certain persons higher allowances than persons with the same income who are thought to have a higher capacity to pay.

16.2 The personal allowances available under the Irish income tax system are the following:

(i) Personal allowance for single, widowed and married persons;

(ii) Child allowance;

(iii) Allowance for single-parent families;

(iv) Age allowance;

(v) Dependent relative allowance;

(vi) Blind persons' allowance, and

(vii) Allowance for employed person taking care of an incapacitated individual.

16.3 There are also certain exemption limits for:

(i) A single or widowed person;

(ii) A married person;

(iii) A single or widowed person aged 65 or over;

(iv) A married person aged 65 or over;

(v) A single or widowed person aged 75 or over, and

(vi) A married person aged 75 or over.

16.4 The amounts of the allowances and the exemption limits for 1981/82 and the proposed amounts for 1982/83, together with the estimated cost of these reliefs for 1980/81 are set out in Appendix 12 (section 1). It is necessary to examine each of these reliefs in detail.

Married and Unmarried Persons

16.5 The personal allowance for a married couple is at present twice that for an unmarried person. Up to 1951/52, the married allowance was less than twice the single allowance. From then until 1956/57 it was exactly twice and from then until 1960/61 it was more than twice the single allowance. With the introduction of PAYE in 1960/61 both the married and single allowances were increased by £84 to compensate for the abolition of reduced rates. It was not until 1978/79 that the married allowance was again increased to twice the single allowance.

16.6 A practice which has been followed in relation to these allowances has been that the combined married allowance and working wife's allowance (abolished by the Finance Act, 1980) should be twice the single allowance. This situation existed for 10 years up to 1932/33 and was restored from 1970/71 until 1978/79 for each year with the exception of 1972/73.

16.7 It can be argued that the present allowance for married persons is too high in relation to the single person's allowance, since the present differential does not take account of the fact that two persons living together and sharing household expenditures can live more cheaply and therefore have a greater taxable capacity than two single persons living separately. However, any effort to reduce the value of the married person's allowance relative to the single allowance would be constrained by the decision of the Supreme Court on 25 January, 1980 in the case of *Murphy v the Attorney General*[1].

16.8 There is a further anomaly in the allowance for married persons in that if a couple is married at any time during the year of assessment, they qualify for the married persons' allowance. In the extreme case, where a

[1]Broadly speaking, the Supreme Court found that those sections of the Income Tax Act which provided for the aggregation of the earned incomes of married couples were repugnant to the Constitution. The effect of this judgement was that married persons would be regarded as single persons for income tax purposes. In the Finance Act, 1980 legislation was enacted which gave married persons the option of being taxed as single persons. Alternatively, they could choose to continue to be taxed as married persons with the tax normally being assessed on the husband. In such circumstances, however, the income tax rate bands applicable and the income tax allowances granted would be double those for a single person.

marriage takes place on 5 April instead of 6 April, there is a significant tax advantage. For example, a man earning £25,000 per year who married on 5 April will be entitled to be assessed jointly with his wife for that year on his total income for the year and on her total income from the date of marriage to the end of the year (in this case one day). She will be assessed as a single person on her pre-marriage earnings for the year. As a result the husband would be entitled to a repayment of tax at 1981/82 rates as follows:

	Single Person	Married Person
	£	£
Income	25,000	25,000
Allowances	1,115	2,230
Taxable Income	23,885	22,770
Tax	12,456	9,912

Repayment £2,544

This anomaly favours the better-off quite substantially. It is also more likely to be exploited by those with a detailed knowledge of income tax legislation. For these reasons, we recommend that, in the year of marriage, both spouses should be taxed as single persons. However, they should have the right to opt to be taxed jointly in the year of marriage. In such a case, any repayment due should be reduced in the proportion that the period of marriage in the year bears to the full year.

Widowed Persons

16.9 Prior to 1954/55, the allowance for widows and widowers was the same as for single persons. In that year the personal allowance was increased by £25 for widowed persons. The differential between the widowed person's allowance and the single person's allowance was increased to £50 in 1974, £60 in 1975, £65 in 1976, £70 in 1977 and £500 in 1982.

16.10 The tax treatment of widowed persons with dependent children is considered under the heading of an allowance for one-parent families. The following analysis applies solely to widowed persons with no dependants. Our proposals for the reform of taxation of inheritances will ensure that no tax is payable by a widowed person on property received on the death of a spouse. It must be said that the present allowance for widowed persons has neither a rational basis nor a solid foundation in equity, since there is no inherent difference in the ability to pay of widowed and single persons with the same income. Indeed, it is anomalous that separated persons do not

qualify for the widowed allowance at present. We consider later whether or not there is a case to be made for an additional allowance for persons living alone.

16.11 There can, however, be hardship in the abrupt change from being charged to tax as a married person to being charged as a single person immediately following the death of a spouse. In these circumstances, income may fall substantially, even though this may be offset in many cases by insurance policies, mortgage protection policies, lump sum payments under superannuation schemes and a reduction in consumption due to the death of the spouse. An attempt to cater for this contingency was made in 1980 when the married allowance was extended to widows in the year of death of their husbands. In addition to discriminating against widowers, the operation of this provision is unsatisfactory in that widows whose husbands die towards the end of the income tax year or who have low incomes after the death of a spouse receive little or no benefit from this concession.

16.12 We recommend that in the year of death of a spouse the income tax allowances or credits should be apportioned on a time basis. The best method of dealing with hardship resulting from the death of a spouse particularly for those not having the benefit of insurance or adequate pensions during a transitional period is through a direct payment from the Exchequer. At present, a death grant is payable under the Social Welfare Acts on the death of an insured person or their spouse. We believe that an extension of this scheme to all surviving spouses would be more equitable and effective than the existing income tax provisions which operate in an arbitrary manner.

Child Allowance

16.13 For children under 16 years of age, or those over 16 years of age and receiving full-time education, there is an income tax allowance of £100. Parents of permanently incapacitated children receive an income tax allowance of £500. Allowances are paid under the Social Welfare Acts in respect of each child who is under the age of 16 years or is between 16 and 18 years and is undergoing full-time education by day, or is an apprentice or is incapacitated and likely to remain so for a prolonged period. These allowances are exempt from income tax. Both allowances are, we believe, intended primarily to help parents to meet minimum levels of expenditure upon their children's needs. It can be argued that it is untidy to have two instruments of policy for the same purposes.

16.14 Since 1969, increases in social welfare children's allowances have been recovered in full or in part from taxpayers on a number of occasions

by reducing the amount of income tax child allowance. Despite these steps there is still inequality in the value of State aid in respect of children as shown in Table 20 which gives the cash benefit in terms of tax saved and payments received from income tax and social welfare child allowances.

TABLE 20

Cash Benefit in 1982/83 from Income Tax and Social Welfare Child Allowances

Taxpayer's marginal rate of tax	State "aid"	First child to fifth child	Sixth and subsequent children
%		£	£
0 (not liable to tax)	Social Welfare	135	210
	Income Tax	0	0
	Total	135	210
25	Social Welfare	135	210
	Income Tax	25	25
	Total	160	235
35	Social Welfare	135	210
	Income Tax	35	35
	Total	170	245
45	Social Welfare	135	210
	Income Tax	45	45
	Total	180	225
55	Social Welfare	135	210
	Income Tax	55	55
	Total	190	265
60	Social Welfare	135	210
	Income Tax	60	60
	Total	195	270

State aid in the form of child tax allowances and social welfare children's allowances is over 44 per cent higher for the first child of a taxpayer liable at 60 per cent than for the child of a person not liable for tax. In the case of the sixth and subsequent children the differential is 29 per cent.

16.15 Table 20 demonstrates a fundamental defect of the present income tax system in its treatment of children, which is that only liable taxpayers obtain a part or all of the value of the income tax allowances granted for children. Under an income tax system with progressive rates, the value of tax allowances in terms of tax relieved increases as income increases. It is clear from Table 20 that, under the existing system, the effective cash

benefits in the form of income tax allowances and social welfare allowances from the State in respect of children are worth more to the better-off [2].

16.16 An alternative method of allowing for children and other dependency obligations is the "quotient system", which is used in France. With a quotient system the starting point is a progressive scale of taxation for a single person. In France, relief from tax is given, in recognition of the taxpayer's marital status and family responsibilities, by means of the "family part" (*quotient familial*) system. Under this, the net total income is divided into a number of parts according to the taxpayer's status and number of dependants and the tax attributable to a single part is multiplied by the total number of parts to give the total amount payable. In the case of a married couple, the income is divided into two parts, and normally one-half of a part is additionally counted for each dependent child. For example, a husband and a wife and two children would pay, as a family, three times the tax payable by a single individual with an income equal to one-third of that of the family. This treatment is obviously more favourable to the family, particularly the high income family than the existing Irish system. This is clear from Table 21 which sets out the tax that would have been payable by a single person, a married couple (quotient 2) and a married couple with two children (quotient 3) at the scale of rates applying to a single person in 1981/82, if a quotient system were in operation in Ireland in that year.

TABLE 21

Tax Payable Under Quotient System at 1981/82 Rates of Tax*

Total income	Single person	Married couple	Married couple with two children	Tax savings per child
£	£	£	£	£
3,000	559.75	192.50	Nil	96.25
6,000	1,609.75	1,119.50	663.75	245.87
9,000	2,936.75	2,169.50	1,679.25	245.12
15,000	6,465.00	4,446.50	3,779.25	333.62
30,000	15,456.00	12,912.00	10,460.25	1,225.88

*The effect of exemption limits is excluded.

16.17 The system in the United Kingdom is quite different. It was one of the principles of the original Beveridge Report[3] that family needs were to be met by a generous system of children's allowances, sufficient to meet the subsistence needs of all dependent children when the responsible parent is in receipt of any insurance benefit or pension, and of all such children

[2] Table 20 does not take account of the child support payments given with certain social welfare payments. For the effect of this see L. Joyce and A. McCashin *Poverty and Social Policy*. Institute of Public Administration, 1982, page 37.

[3] Beveridge, Sir William, *Social Insurance and Allied Services*, Cmd 6404, HMSO, 1942, paras. 19 (iii) and 417.

except the first one in other cases. In other words, family allowances should be paid on an adequate scale unconditionally in respect of

(i) all children except the first in families where the father was at work, and

(ii) all children in other families.

Since that time, public thinking in the United Kingdom has moved in the direction of a unified child benefit combining family allowances in the form of social security payments and child allowances available in the income tax code into standard social security payments payable for all children. This scheme was finally enacted in the Child Benefit Act, 1975.

16.18 As far as Ireland is concerned, the main arguments against the proposal to transfer the support given to children under the income tax to the social welfare system are that

(i) it might increase family stress or pressures for higher wages by increasing the tax deductions payable by fathers in a situation in which social welfare allowances are generally paid to mothers, and

(ii) it would be inequitable in that certain categories of persons such as many farmers are not liable to income tax whereas others escape paying their fair share.

16.19 We do not accept the first argument. In our experience, child care is mainly undertaken by the mother. If directing tax and social security benefits for children towards the mother creates family stress, this is simply an indication that they were improperly directed in the first place. In any case these problems, or any inflationary consequences, would not be as serious as heretofore. Since 1969, various Governments have adopted a policy of reducing the income tax child allowance as social welfare allowances have been increased. This is seen in the reduction of the income tax child allowance from £240 in 1978/79 to £100 in 1982/83. With the extension of income tax to better-off farmers and the general strengthening of measures against evasion, the second argument can no longer be considered to be a problem of the magnitude accorded to it in the past. Against these considerations must be set the increased equity of the proposed system, the administrative savings accruing to tax offices and the reduction in compliance costs which would arise from the integration of the two forms of child support.

16.20 Integrating the income tax child allowance and the social welfare children's allowances into a single child benefit payable to the mother would accord fairly well with the argument that favours selectivity in the State system of transfers, i.e. that State aid should be directed towards those in most need. To a greater degree than at present State support for children

by means of child benefit would give more help to the lower income groups than the existing amalgam of income tax reliefs and social welfare payments which we have shown to be regressive. We recommend that income tax child allowances be withdrawn and that a unified child benefit be made payable to the mother. A supplementary payment should be made in respect of incapacitated children.

16.21 The question then arises whether or not child benefit should be charged to tax. There is an argument on grounds of horizontal equity for not charging child benefit to tax. This is because it is properly regarded as a means of discriminating at all levels of income between the ability to pay tax of families with children and those without children to support. Implicit in our argument in favour of a unified child benefit is the view that there should be a constant absolute difference in the tax payable by families with children and those without children to support. This requires that child benefit be untaxed.

16.22 At present, the social welfare child allowance is payable up to eighteen years provided the child is undergoing full-time education by day. The income tax child allowance is granted irrespective of age provided the child is undergoing full-time education. The United Kingdom child benefit is payable for children up to nineteen years of age. We recommend that the child benefit payment should cease when the child reaches twenty-one years of age or completes full-time education, whichever is sooner. We do not see any conflict between this and our recommendation in paragraph 15.16 that the income of children under 16 be aggregated with that of the family for tax purposes.

Allowance for One-parent Families

16.23 An allowance of £250 for one-parent families was introduced in 1979. This was justified by the Minister for Finance in the budget speech on the grounds that one-parent families were deserving of special consideration. The allowance was raised to £500 in 1980, to £650 in 1981 and to to £1,450 in 1982. The allowance for a widowed parent is now £950. This ensures that all such persons receive, by way of the main personal allowance and the one-parent family allowance, an amount equivalent to the married personal allowance of £2,900.

16.24 We consider that the introduction of this allowance was a recognition of the special needs of single parents. It also strengthened the case for the abolition of the additional allowance for widowed persons. However, we feel that the needs of one-parent families could be more effectively met through the social welfare code than through the income tax system. Accordingly, we recommend that the additional tax allowance for one-

parent families be converted into a social security benefit payable to the parent along the lines set out for the child benefit.

Age Allowance and Age Exemption

16.25 A special age relief for persons aged 65 years or over was first introduced in 1951. The new allowance was intended to give the equivalent of earned income relief to aged persons with small investment incomes. The minimum age relief was increased to £175 for single and widowed persons and to £300 for married persons in 1972. This was the first time that an aged person whose income was solely unearned income could pay less tax than persons with earned income of a similar amount who did not qualify for age allowance. The age allowance was substantially changed in principle with the simplification of income tax in 1974. Prior to that the total age allowance and earned income relief could not exceed a maximum of £500, which meant that aged persons with earned income of £2,000 or over derived no benefit from the allowance. In 1974, the age allowance was transformed into a straight addition to the personal allowances of aged persons irrespective of their income level. These additions were £25 for single and widowed persons and £50 for married persons. This change in principle was introduced solely in the interests of simplification of the income tax code. The allowance was increased to £45 and £145 respectively in 1975, to £80 and £180 in 1978 and to £100 and £200 in 1982.

16.26 In 1977, in order to ensure that no person aged 65 years or over whose income consisted entirely of a social welfare pension would be subject to income tax, exemption thresholds were introduced for these taxpayers. The thresholds were £1,000 for a single person and £1,800 for a married man. Marginal relief applied to income slightly above those figures.[4] In the budget statement of 1980 the Minister for Finance said:[5]

> "The Government are particularly aware of the difficulties and anxieties experienced by many old persons in completing their income tax returns and complying with their tax obligations generally. In many cases this is out of all proportion to the ultimate liability involved. For this reason, I propose to raise the age exemption limits to £2,000 and £4,000 respectively for single and married persons aged 65 years and over. Special exemption limits of £2,500 and £5,000 will be introduced for persons aged 75 years and over".[6]

As can be detected from the Minister's statement one of the objectives behind the granting of the exemption limits was to remove the burden of

[4]The marginal relief ceased at incomes above £2,500.
[5]Dáil Debates, 27 February, 1980, Vol. 318, Col. 76.
[6]The thresholds were increased to £2,300, £4,600, £2,800 and £5,600 respectively in 1981 and to £2,500, £5,000, £3,000 and £6,000 respectively in 1982.

filling in income tax forms for elderly persons with low incomes and consequently low tax bills.

16.27 We do not consider that there is any case for giving special relief such as the age allowance to persons aged 65 years or over regardless of their income. Even with reduced incomes their ability to pay tax is probably the same as young persons who have just started to work and are in receipt of low or modest incomes. We recommend the abolition of the age allowance. We appreciate the problems of elderly persons who may have difficulties in filling income tax returns, particularly as the tax bills involved are often quite small. It is arguable that these difficulties can be exaggerated in the case of persons who have recently retired. Therefore, we suggest that the exemption thresholds should only apply to persons aged 75 years and over. The exemption threshold might be about average earnings in the case of a married couple.

Dependent Relative Allowance

16.28 A person who maintains at his own expense a relative of his or of his wife, who through old age or infirmity is incapable of maintaining himself or herself, is entitled to an annual allowance of £110. The dependant's income must not exceed the maximum amount of the social welfare old age non-contributory pension. To the extent that it does, the allowance is reduced pound for pound in line with the excess. The same allowance is also granted for a widowed mother whether incapacitated or not. Moreover, a person who, through old age or infirmity, is compelled to depend on the services of a son or daughter resident with and maintained by him or her is entitled to the allowance subject to the income limit. The dependent relative allowance was £25 in 1922/23. It was increased to £50 in 1949, to £60 in 1956, to £80 in 1974, to £95 in 1975 and to £110 in 1982. The increases in 1974 and 1975 were in line with general increases in all personal income tax allowances.

16.29 The Commission on Income Taxation in its Seventh Report[7] made a number of recommendations regarding the allowance. These included

(i) The allowance should be related to dependency rather than the subsidiary matter of relationship.

(ii) The allowance should be the same as the child allowance.

16.30 The Government's response to these recommendations was contained in the Second White Paper on Direct Taxation.[8] The recommendation

[7]Prl. 6581, 28 March, 1962 (paras 60-68).
[8]Prl. 7024, April, 1963 (paras 33 and 34).

to relate the allowance solely to dependency was not accepted because "the proposed extension would involve considerable administrative difficulty in establishing dependency and maintenance". The response to the recommendation that the allowance should be of the same amount as the child allowance was unfavourable even though couched in cryptic terms:

> "The moral and legal obligations of parents towards their children as compared with other dependants merit recognition in the income tax system. The amount of the dependent relative allowance will, of course, be considered from time to time in the normal course of budget reviews".

16.31 The proposals made earlier in relation to income tax child allowances would require their integration with social welfare child allowances. Similar proposals in relation to the dependent relative allowance would appear, *prima facie*, to be warranted. The benefit of the allowance accrues at least initially to the person on whom the relative is dependent.

16.32 The case for the allowance is sometimes justified on the grounds that it encourages persons to maintain relatives who are in need. Thus it is argued that, say, in the case of the aged, the granting of the dependent relative allowance actually reduces the burden on the general taxpayer because as a result of the allowance there is less resort to institutional care for the old. We reject this argument for two reasons. Firstly, it takes a somewhat cynical and materialistic view of human relationships. Secondly, and this is more our concern, it is unlikely that the present allowance of £110 per year, which is worth only £38.50 in terms of tax saved to a taxpayer liable at the standard rate, has any more than a negligible effect in this regard.

16.33 However, against this must be set the fact that the allowance gives rise to more abuse than any other allowance in the tax code.[9] This is largely due to the administrative difficulty in disproving dependency in cases in which it is claimed to exist. Approximately 140,000 taxpayers or nearly one taxpayer in five receives the allowance.[10] In the light of these considerations, the best approach would appear to be to remove the allowance and use the proceeds to increase payments to needy elderly persons directly. This would have the beneficial effect of giving direct benefit to old persons with low incomes. Families with whom a dependent relative resides would benefit from the head of household allowance recommended in paragraph 16.44.

[9]Evidence of Chairman of Revenue Commissioners per agreed note of meeting held on 22 December, 1981.
[10]*Fifty-Sixth Annual Report of the Revenue Commissioners for the year 1978*, Prl. 8470 Estimates from Table 77.

Blind Persons' Allowance

16.34 An income tax allowance of £100 for blind persons was introduced in 1971. This allowance was increased in line with other allowances to £140 in 1974, to £165 in 1975 and to £330 in 1980. In 1981, the allowance was increased to £400 and to £1,000 where both spouses were blind. Further increases to £500 and £1,200 respectively were granted in 1982.

16.35 Blindness is only one form of disability and the existence of the allowance raises the question of a general income tax allowance for disability. The matter was considered by the Royal Commission on the Taxation of Profits and Income in its Second Report in the following terms:

> "our general conclusion is that grave disability ought to be the subject of an allowance. It presents itself to us as a personal circumstance that sets apart those who suffer from it and directly affects their relative capacity to pay. We do not mean that it affects their earning capacity. It may or may not, but so far as it does, the graduated scale of tax will diminish the burden on diminished earning power. What we are thinking of is a range of additional expenses attendant upon the conduct of their normal life, not least upon the maintenance of their earning capacity, which yet goes unrelieved under the existing code".[11]

The Commission went on to recommend the introduction of an allowance of not less than £100.

16.36 Against this it might be argued that it is unnecessary to allow for personal disability in the income tax system because allowances are made for it by direct assistance under other schemes. As a general principle, it would appear preferable to make direct payments to those in need rather than provide assistance through the tax system. We recommend that the blind persons' allowance be phased out and assistance given under the Social Welfare Acts or Health Acts as appropriate.

Employed Person Taking Care of an Incapacitated Individual

16.37 In 1969, an allowance was introduced to cover the case in which an individual (or his/her spouse) is totally incapacitated throughout the year of assessment and a person is employed for the purpose of taking care of the incapacitated person. The amount of the allowance was £100. This was raised to £140 in 1974 and to £165 in 1975 in line with general increases in other allowances. The allowance was increased to £330 in 1980, to £500 in 1981 and to £700 in 1982.

16.38 Incapacitated persons who are within the social insurance system

[11] Cmd. 9105, April 1954, para. 202.

may qualify for disability benefit, invalidity pension or injury and disablement benefits. Persons between the ages of 16 years and 66 years who are not entitled to social insurance benefits qualify for the disabled persons maintenance allowance paid by health boards.

16.39 We do not consider that an allowance for incapacitated persons belongs in the income tax code. In particular, to tie the allowance to the employment of an individual is outmoded. The most equitable method of dealing with the additional expenses resulting from incapacity is through direct expenditure under the health services. We recommend that the allowance for an employed person taking care of an incapacitated individual be abolished and replaced, if this is considered necessary, by higher direct payments under the Social Welfare or Health Acts.

Living Alone Allowance

16.40 We now consider the question of whether a new income tax relief should be introduced for persons living alone to take account of the fact that two persons living together can, by sharing expenses, live more cheaply than two persons living separately.

16.41 Persons who live alone can, we feel, reasonably be divided into two categories: those who do so of their own free will and those who live alone because they have, in effect, been left in that condition by circumstances. Into the first category would usually come younger people. Widows, widowers, separated persons and older single men and women would come into the second category, at least in certain cases.

16.42 It would be inappropriate, we think, to compensate persons who live alone from choice by making special provision for them in the income tax code, just as it would not be appropriate to compensate persons who choose to devote a relatively high proportion of their consumption expenditure to highly taxed items. For persons "forced" to live alone the case is not that clear-cut. In general, we believe that the increased expenses which arise from living alone bear most heavily on those at the lower end of the income scale. Taking into account the difficulty in establishing criteria to confine a living alone allowance to the persons whom we think should benefit from it, we do not recommend the introduction of such an allowance. The social welfare code already covers many of the cases of special need which we have in mind through the payment of additional allowances to pensioners living alone.

Head of Household Allowance

16.43 The introduction of a head of household allowance which would apply to persons who have care of dependent adults other than spouses

must be considered. We discussed the administrative implications of introducing such an allowance with the Revenue Commissioners. They foresaw no difficulty in operating an allowance of this kind, provided strict criteria for qualification could be established.

16.44 We recommend the introduction of an allowance of an amount equivalent to the difference between the single and married allowance in cases in which an adult dependent relative is resident with the claimant. In cases in which the allowance is claimed, the dependent relative should be regarded as a member of the family with which he resides and his income should be aggregated with that family for tax purposes.

Exemption Limits

16.45 Exemption limits of general application were reintroduced into the income tax code in 1980. These were set at £1,700 for single and widowed persons and £3,400 for married persons. These limits were increased to £2,000 and £4,000 respectively in 1981. Further increases to £2,200 and £4,400 were granted in 1982. We received a number of submissions which proposed that these limits be increased or extended to take account of family responsibilities.

16.46 Exemption limits cause some administrative difficulty in the operation of PAYE since they cannot readily be implemented until the taxpayer's income is known, which must be after the end of the year of assessment. Prior to this an attempt is made to identify the taxpayers involved. Consequently a significant number of adjustments are required at the end of the year. Exemption limits also require the provision of marginal relief for persons with incomes slightly in excess of the exemption limits. Depending on the size of the exemption limits in relation to the level of personal allowances, this can result in high marginal rates of tax on significant numbers of taxpayers with below average incomes. For example, over 50,000 low income taxpayers had a marginal tax rate of 60 per cent in 1981/82. We believe that this is undesirable.

16.47 We also believe that general exemption limits are misconceived in principle, since to help the poor effectively it is unnecessary to relieve them from taxation but rather to ensure that they have an adequate income by means of social welfare payments. We do not recommend that general exemption limits remain as a permanent feature of the income tax code.

Tax Credits

16.48 Under the present Irish income tax system, all allowances for dependency or other obligations are given in the form of deductions from

income. We received a number of submissions which proposed that allowances be given in the form of credits or direct social welfare payments.

16.49 Tax credits may be refundable or non-refundable. When they are refundable, low income earners who have unused credits receive a cash grant from the State equal to the unused amount. It is readily apparent how such a system might be part of an integrated approach to income maintenance.

16.50 The attractions of such an integrated approach[12] are simplicity, avoidance of high implicit marginal rates of tax on income-related social transfers (thereby helping to overcome the so-called "poverty-traps" problem) and sharper definition of the scope of welfare schemes. While the refundable tax credit system could be operated through PAYE, the fact that a relatively high proportion of the population in Ireland is self-employed raises some difficulties in the way of introducing it here.

16.51 We are concerned in the first place with whether or not tax allowances should be converted into non-refundable credits in the interest of equity, efficiency and simplicity. The introduction of refundable tax credits is considered in Chapter 23.

Advantages and Disadvantages of Tax Credits under a Progressive Tax System

16.52 The difference between tax credits and allowances is simple. A tax credit involves a reduction in taxes of a given amount, while an allowance grants a reduction in taxable income. The latter results in a tax reduction that increases with income, if tax is charged at progressive rates. Because an allowance excludes from tax the last pounds of income received by a taxpayer, the value of an allowance to a taxpayer depends on the marginal rate of tax paid by that taxpayer. This is clear from the fact that an increase in the married allowance of £100 results in a tax reduction of £60 to the taxpayers at the top of the scale and £25 to taxpayers whose marginal rate is the reduced rate.

16.53 On the other hand, a tax credit, effectively exempts a given amount of the first pounds of a taxpayer's income. It is of equal value to all taxpayers. An increase in a tax credit of £25 saves all taxpayers £25, except those who are at the very bottom of the scale and are exempted from tax as a result of the increase.

16.54 Therefore, a tax credit affects all taxpayers equally while an allow-

[12] *Negative Income Tax*, OECD, 1974.

ance increases in value as income increases. In other words, the revenue loss resulting from the use of allowances is higher than from the use of credits, where credits and allowances achieve the same result for low income families.[13] However, adjustments to the scale of rates can be made to produce identical liabilities for single taxpayers where single persons are given either an allowance or a credit. Provided there is a separate rate structure for married persons or any other category, this can also be adjusted to produce identical liabilities under credit and allowance systems. Differences arise where a particular category of taxpayer does not have its own rate structure.

16.55 On this basis, there is a clear case for converting all allowances than the married and single persons allowance into credits. However, we also believe that the married and single allowances should be given in the form of credits for three main reasons. Firstly, it would mean a complete change to credits. This would simplify the operation of PAYE compared to a system in which there were both allowances and credits. Secondly, a credit system is easier for the taxpayer to understand in so far as the rate structure is defined in terms of total income or expenditure rather than taxable income under an allowance system. This enables a taxpayer to identify his marginal rate of tax more easily. Thirdly, under a credit system it is much easier to give equal absolute increases in income to all single or married taxpayers. While this can be achieved under an allowance system, it is more complicated in that rate band adjustments are necessary.

16.56 A possible disadvantage of a change from tax allowances to tax credits would be that it would inevitably draw attention to the very low value of some existing tax reliefs. For example, the present dependent relative allowance is worth only £38.50 per year or 74 pence per week to an individual liable at the standard rate of tax. This could lead to pressure to increase these reliefs. We do not believe that this is a disadvantage. If reliefs are justified in principle, they should be set at levels which reflect existing money values. If they are not justified, they should be removed.

16.57 We recommend that all tax reliefs which remain in the direct tax code after our recommendations in paragraphs 16.5 to 16.47 have been acted upon should be given in the form of tax credits.

Amounts of Tax Credits

16.58 We now have to consider the appropriate level of tax credits for tax purposes. To reach a conclusion on this matter requires coming to a view

[13]The greater efficiency with which credits assist low income taxpayers was the factor which influenced the Carter Commission to propose the introduction of credits with the objective of reducing the tax burden on low income families. *Report of the Royal Commission on Taxation* Vol. 3 pp 180–181.

on the purpose of personal allowances or tax credits. Generally speaking, there are two views about the purpose of personal tax allowances.[14] The traditional view regards them as representing some notion of minimum income which should not be taxed. The second approach regards personal tax allowances solely as a part of the progressive structure of the tax system to ensure that there is horizontal equity between persons with the same income but different dependency and other obligations. Those who adopt the second approach believe that the most efficient method of dealing with the problem of low incomes is by means of direct payments from the Exchequer.

16.59 The traditional view of personal allowances dates from a period in which poverty was thought of primarily in absolute terms rather than in terms of relative deprivation. In addition, the amount of revenue required to be raised in taxation in general, and direct taxation in particular, was such that there was no difficulty in relieving persons on low incomes from liability. If personal allowances are fixed at a minimum income level, which is considerably higher than the existing level, a steep increase in the marginal rates of tax applying to those on average incomes and above would be necessary, if the tax yield were to be maintained.

16.60 We believe that the most effective and efficient method of helping the poor is not to exempt them from taxation, but to ensure by means of income maintenance payments that they have an adequate income. This is the approach which has to be adopted in the case of indirect taxation and we believe that it is appropriate for direct taxation also. The income tax system cannot be used to help people who have no income—those who need help most. The sole purpose of tax credits should be to achieve horizontal equity between persons with the same income but different dependency and other obligations. In principle, therefore, the credit for single persons could be set at any level and the level of all other credits fixed to ensure that the relative tax payable by other categories is satisfactory in relation to single people.

Equivalence Scales

16.61 In its submission to the Commission, The Society of St. Vincent de Paul stated that

> "the value of the various personal allowances (and of dependents' allowances in the social welfare system) indicates that they are set without reference to any objective assessment of need. The Society therefore recommends that regular full examination of the cost of basic expenses of households of different composition should be undertaken.

[14]See Appendix 13.

The findings should form the basis of equivalence scales for use in setting tax allowances or credits. The equivalence scales should be published annually".

16.62 Households and families differ in size and composition. Equivalence scales, which have been proposed as a means of converting household and family incomes to a common basis, are essentially ratios of incomes required by different household and family types to achieve a similar standard of living—taking into account the economies possible in the larger households from sharing of facilities, including heating and lighting and purchases in bulk. The related concept of equivalent income is defined as a household's actual income divided by its equivalence scale. A married couple with no children may be taken as the standard household with scale 1, a single person might be given a scale of 0.6 and a couple with two children 1.5.[15] These values imply that a married couple with an income of £100 per week are as well off as a single person with £60 or a couple with two children with £150 a week.

16.63 Equivalence scales may be estimated from expenditure data or based on scales implicit in social welfare or taxation codes. There are problems about the accuracy of expenditure data on particular items like alcohol and tobacco. Moreover, it is difficult to select a criterion for determining when two households of a different composition (e.g. a couple with two children and a couple without children) have the same standard of living. For families having the same composition, e.g. married couples without children, it is reasonable to suggest that those with higher incomes have a higher standard of living but there is no such unequivocal and indisputable criterion generally available when the families differ in their composition. Thus, equivalence scales and comparisons of living standards result from judgements which may be arbitrary and on which opinions differ. Judgements which are plausible when applied to a low standard of living can become clearly implausible when applied to low and high standards alike. Generally speaking, the less obviously plausible the criteria, e.g. that families at all income levels have the same standard of living if they spend the same proportion of their income on food, the easier the computation and *vice versa*. It is also difficult to assign a definite meaning to standard of

[15]These ratios have been abstracted from Appendix E to Report No. 6, *Lower Incomes, Royal Commission on the Distribution of Income and Wealth*, May 1978, Cmnd. 7175. Thus, these figures relate to the United Kingdom. The Appendix cites L. D. McClements' *Equivalence Scales for Children*, 1975, an unpublished Department of Health and Social Security paper as one of its sources. On this work E. Fitzgerald in N.E.S.C. Report No. 47 *Alternative Strategies for Family Income Support* makes the following comment at page 63:

"It was felt that rounding the equivalence values found by McClements would give a reasonable approximation to the results which might be obtained by the theoretically more desirable approach of deriving first equivalence scales based on Irish household spending patterns, and then applying these".

living when applied to a family. Part of the difficulty is avoided if goods supplied on a non-market basis, e.g. housing subsidies, are excluded. Even so it is difficult to assess the collective standard of living of a family. Appendix 14 compares equivalence ratios applied or proposed in various countries.

16.64 We consider that, in principle, tax credits should be set by reference to equivalence scales. We recommend that work should be undertaken to establish appropriate equivalence scales for Ireland, which would at least provide an approximate guide for the legislature in determining the appropriate relative amounts of tax credits.

Tax and Social Welfare

16.65 Our proposals put the responsibility for income maintenance firmly on the income maintenance schemes operated by the Department of Social Welfare. Following the development and expansion of social welfare, we see a much reduced role for the direct tax system in this area than has been the case in the past. Tax relief, in our view, is a most inefficient method of helping the poor. It has not been part of our task to come to a view on whether the income maintenance system can adequately meet this challenge or does so at present. However, since this is its prime function, we believe that it should be capable of doing so.

Recommendations

16.66 We make the following recommendations:

1. In the year of marriage, both spouses should be taxed as single persons. However, they should have the right to opt to be taxed jointly in the year of marriage. In such a case, any repayment due should be reduced in the proportion that the period of marriage in the year bears to the full year.

2. Widowed persons with no dependent children should be charged to tax as if they were unmarried.

3. On the death of a spouse, a death grant should be payable to mitigate any hardship which arises.

4. Income tax reliefs for children should be abolished and integrated with social welfare children's allowances to be made payable in respect of all children up to the age of 16 years or up to 21 years where the child is undergoing full-time education. A supplementary payment should be made in respect of incapacitated children These benefits should not be subject to tax.

5. The additional allowance for one-parent families should be con-

verted into a social security benefit payable in association with child benefit;

6. Age allowance should be abolished.

7. Age exemption limits for persons aged 75 years or over should be retained. For married couples the exemption threshold might be set at about average earnings.

8. The dependent relative allowance should be abolished.

9. The blind persons' allowance should be integrated with direct payments made under the Social Welfare or Health Acts.

10. The allowance for an employed person taking care of an incapacitated individual should be abolished and replaced, if necessary, by direct payments.

11. A head of household credit should be introduced in cases in which a dependent adult relative is resident with the claimant. The credit should be equal to the difference between the credit for single and married persons. In cases in which the credit is claimed, the dependent should be regarded as a member of the tax unit with which he resides and his income should be aggregated with that unit for tax purposes.

12. Exemption limits of general application for income tax purposes, in excess of those which result from the granting of allowances or credits, should not remain as a permanent part of the income tax code.

13. All tax reliefs which remain in the direct tax system after all our proposals in paragraphs 16.5 to 16.47 have been acted upon should be given in the form of tax credits.

14. The sole purpose of tax credits should be to achieve horizontal equity between persons in different circumstances. They should not be regarded as a means of exempting a particular minimum level of income from taxation.

15. Work should be undertaken to establish appropriate equivalence scales for Ireland, in order to provide an approximate guide for the legislature in determining the appropriate relative amounts of tax credits.

CHAPTER 17

THE INCOME TAX RATE STRUCTURE

Introduction

17.1 In this chapter we conclude that there should not be a reduced rate of income tax. We recommend in Chapter 18 that the higher rates of income tax be replaced by a direct expenditure tax. Taken together, these proposals make it possible for income tax to be levied at a single rate. This has very great advantages. It enables the tax base to be expanded. Taxation can then be neutral between income gains and capital gains and between retained and distributed profits of companies. This allows enormous simplification of the taxation system and reduces the scope for tax avoidance.

The Existing Rate Structure

17.2 The 1982/83 personal income tax rate structure in Ireland has a number of basic features:

(i) The scale is progressive with increasing marginal rates levied on successive slices of taxable income, from 25 per cent on the initial £1,000 of taxable income to 60 per cent on taxable income in excess of £8,000. In the case of married persons jointly assessed these taxable income figures are doubled.

(ii) The progression is achieved by charging tax on slices of income — five in all — which are subject to progressively higher marginal rates.

(iii) Progression is also achieved by using personal allowances and exemption limits which effectively exempt from income tax the first slice of income. Where income slightly exceeds the exemption limit, marginal relief ensures that tax payable is limited to 60 per cent of the excess of income over the exemption limit.

(iv) The nominal progression is effectively reduced by a large number of allowances and reliefs and the exclusion from the tax base of certain items of income.

The Reduced Rate

17.3 Rates of income tax which are lower than the standard rate (at present 35 per cent) are known as reduced rates. Reduced rates were a feature of the income tax system until 1960, when they were abolished to facilitate the introduction of PAYE. A reduced rate of 23.33 per cent on the first £100 of taxable income was reintroduced in 1970 but was removed in the following year. A reduced rate of income tax was reintroduced in 1974 to compensate for the abolition of earned income relief.

17.4 The process of graduating the income tax rate structure at the bottom of the scale was taken a step further in 1977 when an initial rate of 20 per cent was imposed on the first £500 of taxable income and a reduced rate of 25 per cent charged on the next £1,000 of taxable income. This was part of a general restructuring of income tax rates. In changing the rate structure in 1977, the Minister for Finance stated in his budget speech that the

> "introduction of a new band at 20 per cent will be of considerable benefit to the lower-income taxpayer".[1]

The initial rate of 20 per cent was abolished in 1979 and now there is only one reduced rate of 25 per cent which is charged on the first £1,000 of taxable income (£2,000 for married couples jointly assessed).

17.5 There are clear administrative advantages to be obtained from reducing the number of different rates of tax and by having a single rate for the vast majority of taxpayers. In these circumstances, deduction of tax at source works more effectively in that there is a higher probability that the amounts withheld from income will be correct and end-of-year adjustments will not be needed. The provision of two additional PAYE tables which are necessary to cope with the reduced rate also make the system that much more complicated for employers to operate. Therefore, there are administrative arguments for removing the reduced rate but these would be insufficient if there were strong economic and social arguments for retaining it.

17.6 Our proposals involve a significant extension of the income tax base. Other things being equal, this implies a reduction in the existing standard rate of income tax. We now consider whether a lower rate of, for example, 15 per cent or 20 per cent should be applied to the first band of taxable income. Two main arguments are normally advanced to justify the charging of a reduced rate of income tax. Firstly, it is said that a reduced rate band gives particular benefit to the lower paid. Secondly, to charge tax at the

[1]Budget speech 26 January, 1977.

standard rate on low incomes would damage incentives to work. Neither of these arguments stands up well to examination.

Benefit to the Lower Paid

17.7 It may appear obvious that a reduced rate of tax benefits the lower paid. However, this is not so. The introduction of a reduced rate has a cost in terms of revenue foregone. To examine the distributional implications, we must consider alternative uses for this revenue. We have been informed by the Revenue Commissioners that the abolition of the reduced rate for 1981/82 would have enabled the single allowance to be increased by £275 and the married allowance by £550. The net effect of these changes would have been to increase the take-home pay for single persons with income between £2,200 and £2,600 and for married persons with income between £4,400 and £5,200. Persons with incomes above these levels would have lost slightly. Therefore, the abolition of the reduced rate could make the income tax system more progressive by shifting part of the burden from the lower paid to the higher paid.

Disincentive Effects

17.8 The second reason advanced for having a reduced rate is the concern about the disincentive effects which high marginal rates of tax have for lower paid employees. Marginal tax rates are the rates payable on additional income. To see how the existing reduced rate of tax affects lower paid employees it is necessary to examine the effective marginal rates of tax which are in force. The marginal rates in the case of employees who qualify for basic personal allowances only (at 1981/82 rates of tax) are as shown in Table 22.

TABLE 22

Marginal Rates of Income Tax 1981/82

Single Persons		Married Persons	
Slice of Income	Marginal Rate* of Tax	Slice of Income	Marginal Rate* of Tax
£	%	£	%
0, — 2,000	0	0 — 4,000	0
2,001 — 2,203	60	4,001 — 4,838	60
2,204 — 2,715	25	4,839 — 13,000	35
2,716 7,215	35	13,831 — 17,830	45
7,216 — 9,215	45	17,831 21,830	55
9,216 11,215	55	21,831 and over	60
11,216 and over	60		

*In the case of employees liable for the ordinary rate of pay-related social insurance contribution an additional 4.75 per cent was levied on income up to £8,500.

17.9 The Revenue Commissioners have informed us that the estimated number of taxpayers at the different marginal rates for 1981/82 were as shown in Table 23.

TABLE 23

Number of Taxpayers at Different Marginal Rates of Income Tax 1981/82

Marginal Rates of Tax	Number of Taxpayers	Percentage of Taxpayers
%	000's	%
60 (bottom of scale)	51.5	6.6
25	38.2	4.9
35	553.5	71.2
45	78.8	10.1
55	31.0	4.0
60 (top of scale)	24.8	3.2
	777.8	100.0

17.10 There are no data on the employment status of taxpayers who have a marginal rate of tax equivalent to the existing reduced rate of 25 per cent. Some of them are clearly individuals in full-time jobs who worked for only part of the year, such as school-leavers in their first jobs or persons who died or emigrated during the year. The only information available shows that about 34 per cent are single, 15 per cent are widowed and 51 per cent are married.

17.11 We conclude that since the level of earnings to which a reduced rate applies is relatively low, the majority of individuals whose marginal rate is a reduced rate are either young single people, retired persons, widowed persons or persons in part-time employment. We believe that if there is a problem with regard to work incentives in Ireland it applies higher up the income scale where moonlighting is more common. We consider that there may be some disincentive effect when persons move from a reduced rate to a standard rate. This arises not from the level of taxation, but the perceived increase of taxation of marginal earnings. On this basis, we conclude that the case on incentive grounds for a reduced rate of tax at the bottom of the income scale is weak.

Higher Rates of Tax

17.12 In Chapter 18 we conclude that the higher rates of income tax should be replaced by a direct expenditure tax which will give the tax and public expenditure systems the desired degree of progressivity at the higher end of the scale of income and wealth.

Conclusion

17.13 We conclude that the objective should be to levy income tax at a single rate. This would enable major improvements to be made to the Irish tax system. We envisage that this rate would be levied on a much wider base than at present. Progress towards a comprehensive tax base, which is implied in the notion of redistribution and which is at the heart of the case for progression in tax rates, has been frustrated by a tendency to avoid the problems caused by the impact of progression on irregular receipts by excluding such receipts from the tax charge altogether. We believe that much more attention needs to be paid to what is to be redistributed. Because of the restricted base on which income tax is levied in Ireland, the income tax system is clearly inadequate as an instrument of redistribution. For example, actual income in income tax assessments made by the Revenue Commissioners in 1978/79 amounted to 49.9 per cent of personal income for 1978 as shown in the National Accounts. This suggests that, at present, income tax is a tax on earnings rather than an instrument for redistributing resources effectively. Our proposals require that redistribution be achieved by means of the direct expenditure tax and the capital taxes which we recommend in later chapters of this report.

Recommendations

17.14 We make the following recommendations:

1. There should not be a reduced rate of income tax.
2. The objective should be to charge income tax at a single rate (subject to our conclusion in Chapter 18 on the introduction of a direct expenditure tax).

CHAPTER 18

DIRECT EXPENDITURE TAX

Introduction

18.1 Equity requires some degree of progressivity in the tax and public expenditure systems. This means that when all State taxes and benefits are paid and received the better-off should be somewhat worse off and the position of the poorer sections of the community improved. The system of direct taxation must be capable of achieving a measure of progressivity at the higher ranges of income and wealth. In this chapter we consider how this should be achieved.

18.2 We have recommended that income tax be charged at a single rate on ordinary income, realised capital gains and gifts and inheritances. This has very great advantages. It enables the tax base to be expanded. The tax system is then neutral between income gains and capital gains, thereby allowing significant simplification and reducing the scope for tax avoidance. It is neutral also between incorporated and unincorporated businesses and between the retained and distributed profits of companies. A single rate of tax at a relatively low rate would enable capital to be accumulated by individuals out of earnings for investment purposes. When set against these advantages, it is clear that the price to be paid for having a nominally progressive income tax schedule is high, without such a system achieving very much in the way of redistribution.

18.3 The main disadvantage with charging income tax at a single rate is that it removes the major progressive element in the tax system. We believe that an acceptable degree of progressivity can be brought into the tax system partly by tax credits, partly by extending the tax base and removing tax reliefs and reducing the scope for tax avoidance but, in particular, by means of a sur-tax on expenditure. In these circumstances, we recommend the introduction of a direct expenditure tax at progressive rates to apply to individuals with relatively high expenditure.

Definition

18.4 A direct expenditure tax is a tax levied on personal consumption spending. It is important to distinguish between a direct expenditure tax

and indirect taxes on expenditure such as value-added tax or excise duties. The principal distinction between these two forms of taxation is that with a direct expenditure tax it is the aggregate amount of expenditure during the accounting period which determines the liability, whereas with indirect taxes the tax payable on a particular item is unaffected by an individual's personal circumstances or the amount of his expenditure on other items. Our brief discussions of indirect taxation in Chapter 4 indicated that this form of taxation cannot be used, with any certainty, to increase the progressivity of the system.

18.5 Liability to a direct expenditure tax would differ from a tax charged on income in so far as savings would be effectively exempt from the tax and consumption financed by borrowing or out of realisation of capital would be charged.

Background

18.6 The idea that the taxation of individuals should be based on consumption and not on income is not new. Over three hundred years ago, Hobbes[1] argued the case in equity for taxing people in accordance with what they consume rather than what they earn. It was restated on rather different grounds in the middle of the nineteenth century by John Stuart Mill,[2] who also argued the case before the Select Committee on Income and Property Tax of 1861. Mill's advocacy was taken up by a number of distinguished economists like Marshall and Pigou in the United Kingdom and Irving Fisher in the United States.

18.7 Discussion of a direct expenditure tax resumed in the 1950s. Professor (now Lord) Kaldor, a member of the Royal Commission on the Taxation of Profits and Income, circulated a memorandum arguing the case for such a tax. The then Chancellor of the Exchequer ruled that the subject fell outside the Royal Commission's terms of reference. After the Royal Commission had reported, Professor Kaldor incorporated his ideas into a book[3] which was published in 1955. Kaldor went beyond the theoretical arguments in favour of a direct expenditure tax and sought to consider how far such a tax could in fact operate currently in the United Kingdom. His main proposal was that sur-tax should be replaced by a tax on expenditure.

18.8 More recently the introduction of a direct expenditure tax has been given an impetus by the proposals for a cash flow consumption based tax put forward by the Department of the Treasury in the United States[4] and

---

[1] T. Hobbes, *Leviathan*, Chapter 30.
[2] J.S. Mill, *Principles of Political Economy*.
[3] N. Kaldor, *An Expenditure Tax*, 1955.
[4] *Blueprints for Basic Tax Reform*, Department of the Treasury, January, 1977.

by the Report of the Meade Committee[5] in the United Kingdom. The Swedish Commission on Taxation[6] made a detailed study of a progressive expenditure tax as an alternative to income tax and recommended conversion of the progressive income tax into a proportional income tax with a 30 per cent rate and the introduction of a sur-tax on expenditure in excess of 30,000 kroners.

Sur-Tax versus Progressive Income Tax Expenditure

18.9 We now consider the relative merits of progressive income tax and a sur-tax on expenditure as a means of providing the essential element of redistribution at the higher end of the scale of income and wealth. The social welfare system would then provide the desired element of redistribution at the bottom end of the scale and the direct expenditure tax would ensure that the tax and public expenditure systems had the desired degree of progressivity at the top end of the scale. The inadequacies of a progressive annual wealth tax as a mechanism for achieving progressivity are dealt with in Chapter 35.

Equity

18.10 Throughout this report we identify certain defects in the base for direct tax as we see them. These are so extensive that it is true to say that there is only a partial direct tax on income in Ireland at present. The present direct tax base can be extended but if progressive direct tax rates are retained it is impossible to extend the tax base fully and still maintain an acceptable degree of progression in the rate structure. This is particularly important in three areas. These are (i) capital gains realised in the long term, (ii) income accruing to companies and (iii) gifts and inheritances. Since these three elements of our concept of income do not accrue in equal proportions to all individuals and families, their exclusion from the tax base or their taxation at favourable rates has important implications for the equity of the tax system.

18.11 It has been argued[7] that a direct expenditure tax is a more effective instrument than an income tax with which to achieve progression in the tax system. High nominal rates of income tax have not achieved effective redistribution of income in the United Kingdom. They have worked as intended on income from employment, less effectively on income from self-employment and hardly at all on returns from capital. The reaction to this failure to achieve redistribution has been to increase the nominal rates

[5] *The Structure and Reform of Direct Taxation*, Institute of Fiscal Studies, 1978.
[6] Sven — Olof Lodin, *Progressive Expenditure Tax — an alternative?* A Report of the 1972 Government Commission on Taxation, Liber Förlag, Stockholm, 1978.
[7] J.A. Kay and M.A. King, *The British Tax System*, Oxford University Press, 1980 p.240.

of income tax. This has had adverse efficiency effects, encouraged tax avoidance and evasion and has not achieved equity because the tax base remained inadequate.

18.12 The most important distinction between a direct expenditure tax and an income tax is that in the case of the former there is a charge on dissavings. One of the main arguments for a wealth tax which we consider in Chapter 35 is that wealth confers on its holders the opportunity to consume more than their income. To the extent that this opportunity is exercised, it will be charged to expenditure tax which may achieve some of the equity objectives sought by the proponents of wealth tax without the adverse economic effects on wealth creation and investment. Tax liability is also related directly to consumption which is equal to a person's standard of living.

18.13 A direct expenditure tax is considerably more difficult to avoid than an income tax since no distinction is necessary between receipts which accrue in different forms. The loss of tax owing to avoidance should, therefore, be considerably less. Under an income tax system, large discrepancies may exist between income charged to tax and living standards, since there is greater scope artificially to reduce income rather than expenditure without reducing living standards.

Efficiency

18.14 The charging of ordinary income, realised capital gains and gifts and inheritances at a single rate has important implications for efficiency. At present, the returns to different forms of activity are distorted by the different rates of taxation applying to various forms of income. Typically, income in the form of earnings pays tax at the highest rates, i.e. up to 60 per cent, while income in the form of realised capital gains has up to now attracted tax at a maximum rate of 30 per cent. It is not surprising that turning income into a form in which it is regarded as a capital gain has been the lynch-pin of many tax avoidance schemes. Following the changes proposed in the 1982 budget, there may be less of an incentive to turn capital gains into income gains.

18.15 We show in Part IIB of this report the difficulties which arise in taxing income which accrues to companies on a satisfactory basis when income tax is charged at progressive rates. If a single rate of tax were applied to all forms of income, it would be possible to avoid all the distortions and many of the avoidance schemes which arise from the use of companies to obtain more favourable tax treatment for company income than that accorded to income in other forms.

18.16 As we noted in Chapter 11, the present income tax system treats

savings in different forms in different ways. While the tax system could be moved closer to neutrality between different forms of savings with a progressive income tax, if income tax at a single rate is supplemented with a progressive tax on expenditure this process can be taken further, leading to greater gains in efficiency.

Simplicity

18.17 The replacement of the higher rates of income tax with a progressive tax on expenditure would allow a number of important simplifications to be made in the income tax system. When income tax is charged at a single rate, it is much easier to deal with withholding of tax from subsidiary sources of income such as second jobs or investment income. For example, at present, distributions from companies carry a tax credit at the normal rate of 30/70 ths of the net distribution. This is equivalent to tax at the rate of 30 per cent on the gross amount of the distribution and the tax credit. Since this rate of 30 per cent does not correspond with any marginal rate of income tax, this means that there must be an adjustment of liability in every case in which such income arises. The charging of income at a single rate of tax would allow an expansion of withholding tax at source. We see this as an important anti-evasion measure.

18.18 In addition, under our proposals, the rate of corporation tax would be the same as the rate of tax on income. This would mean that the general system would be completely neutral between retained and distributed profits. As a result, there would be no need for special anti-avoidance legislation for close companies.

Conclusion

18.19 We believe that the improvements in the income tax system which the introduction of a direct expenditure tax would permit are so significant that the introduction of such a tax is desirable in principle. On this basis, we now consider the difficulties which need to be overcome before this can be done.

Information Needed to Administer a Direct Expenditure Tax

18.20 Early advocates of a direct expenditure tax thought that the principle could only be given effect by a direct assessment of personal consumption. This was thought to be wholly impracticable owing to the difficulty of compelling taxpayers to keep accurate records of their personal expenditure and of checking their returns. This was the method used to assess the amount of tax payable in India and was one of the main reasons for the failure of the experiment in that country.

18.21 Fisher[8] was the first to show that comprehensive records of personal expenditure are unnecessary for the administration of the tax. Fisher's idea was that since what a man spends is nothing else but the difference between what he had available for spending and what he is left with, personal consumption can be computed for tax purposes by taking his income, adding monies received from the sale of capital assets, depletion of bank balances, etc. (i.e. dissavings) and deducting sums spent on the purchase of capital assets and on "non-chargeable" expenditure (i.e. savings).

18.22 This method of assessment may best be understood by examining what an assessment for these purposes might look like. Broadly, the assessment form could be as set out in Table 24.

TABLE 24

Assessment Form for Comprehensive Direct Expenditure Tax

	£	£
1. *Add*		
Personal income		
Wages and salaries	20,000	
Dividends	1,000	
Interest	500	
Rent	1,500	
Net Profits (Losses)	Nil	
Royalties	Nil	
		24,000
2. *Capital receipts*		
Realisation of capital assets	2,000	
Amount borrowed	5,000	
Receipt of repayment of past loans	1,000	
Reduction in money balances	Nil	
		8,000
3. *Windfalls*		
Inheritances	Nil	
Gifts received	2,000	2,000
Total chargeable items		34,000
4. *Deduct*		
Non-consumption outgoings		
Acquisition of assets	10,000	
Amount lent	Nil	
Capital repayment of past borrowings	1,000	
Increase in money balances	1,000	
Gifts made	Nil	
		12,000
5. *Chargeable balance*		
(Representing Expenditure on consumption)		22,000

[8]Irving Fisher, "Income in Theory and Income Taxation in Practice" *Econometrica*, January, 1937.

18.23 Table 24 gives no more than a general idea of the method of calculation. However, the principles are clear. All receipts should be included in items 1, 2 or 3 and item 4 should include all those expenditures which it is desired to treat as not being taxable consumption expenditures.

18.24 Table 24 shows that the tax return required for a direct expenditure tax would be more detailed than the present income tax return. Only those details under item 1 would definitely be included in the present return of income. The first categories under items 2 and 4 would generally also be included, if the assets disposed of or acquired are chargeable assets for capital gains tax purposes. Gifts and inheritances might also be returned for capital acquisitions tax purposes. Overall there would be an increase in the amount of information required. While this would impose an additional burden on both the Revenue Commissioners and the taxpayer, it would make it easier to combat tax evasion.

Practical Difficulties

18.25 We asked the Department of Finance and the Revenue Commissioners for their views on the administrative implications of introducing a sur-tax on direct expenditure. They identified certain difficulties which we consider later and concluded that

> "The theoretical case for an expenditure tax is based on a comparison of a comprehensive income tax with a full range personal expenditure tax. Ireland does not have a comprehensive income tax (including gifts, capital gains, inheritances, winnings, welfare benefits etc.) so that a switch to a personal expenditure tax would represent more than the replacement of an old base with a corresponding new one. This lack of correspondence in the tax bases would exacerbate the difficulties associated with replacing higher rate income tax with expenditure surtax . . . there are grounds for serious reservations about replacing any part of the income tax system with a personal expenditure tax".

18.26 The proposals made elsewhere in this report involve a substantial move in the direction of a comprehensive income tax base. This would clearly make a direct expenditure tax much easier to administer since most of the information required to do so must in any event be supplied for the type of tax on income which we have in mind. However, a number of problems still arise with a direct expenditure tax. The main areas of difficulty appear to us to lie in the following areas:

(i) Identification of taxpayers.

(ii) Treatment of assets.

(iii) Assessment and collection of tax.

(iv) Fraud and evasion.

Identification of Taxpayers

18.27 The problems in identifying taxpayers liable to a direct expenditure tax were explained to us by the Department of Finance and the Revenue Commissioners in the following terms:

> "A very serious problem would be to devise a means of identifying the taxpayers to be made liable to the new tax. A threshold based on income as computed for income tax would defeat the most basic objectives of switching to an expenditure tax and would leave the way open for avoidance. A threshold based on personal expenditure would be difficult to enforce and could negative any advantages to be gained from confining the change to an expenditure sur-tax. It is one thing to monitor high income taxpayers with expenditure consistently above the threshold, quite another to pick up one who spends heavily for a shorter period or intermittently. The physical task of identifying cases for the issue of expenditure returns, the sending of returns to the selected cases and the following up and checking of returns would be quite formidable. Many of the returns would indicate that no liability to expenditure sur-tax arose and much of the work would therefore be unproductive".

18.28 The identification of taxpayers would give rise to some problems. Legislation would be needed to require every individual whose annual consumption expenditure was in excess of the exemption threshold to notify the Revenue Commissioners. Provision would also have to be made for the imposition of penalties on those who failed to comply with this obligation. Similar procedures were adopted in the case of the wealth tax which was introduced in 1975.

18.29 We believe that the information already available to the Revenue Commissioners would enable them to identify the vast majority of taxpayers liable for direct expenditure tax. A problem arises because the Revenue Commissioners have not required all PAYE taxpayers, even those with relatively high incomes, to submit returns of income every year. We do not consider that this practice, which has been adopted as a means of coping with the pressures on the Revenue Commissioners' organisation, should be continued as a long-term policy, even if a progressive income tax were to be retained for a period of time. The resources which would be freed, as a result of the conversion of income tax into a proportional tax, could be used to administer the direct expenditure tax.

18.30 There is no doubt that the arrangements we propose would not enable the Revenue Commissioners to identify every taxpayer liable to direct expenditure tax, just as the Revenue Commissioners fail to identify all persons liable to income tax at the present time. However, we consider that with proper planning and efficient administration, the identification of persons liable to the new tax would not prove to be an insurmountable problem.

Treatment of Assets

18.31 A direct expenditure tax must be operated by the income adjustment method outlined in paragraph 18.22. In principle, this adjustment, which we refer to as the "expenditure tax adjustment", requires that all purchases of assets should be deducted from the tax base and all sales of assets as well as the income yield should be added to the tax base. In most cases, it is a simple matter to say whether a particular item of expenditure should be regarded as saving or as consumption. Difficulties would arise when an individual acquires assets which do not fall clearly into either category. To overcome this problem, the Meade Report suggests that assets be divided into two distinct classes which we refer to as "listed assets" and "unlisted assets"[9]. Only transactions in listed assets would be debited or credited to taxable income so that the expenditure tax adjustment would include disposals less acquisitions of listed assets. All transactions in unlisted assets would be omitted from the calculation. The income yield on unlisted assets would normally be included in the tax base. This would mean that unlisted assets would receive the normal income tax treatment. Any income out of which they were purchased would be subject to tax, but the capital proceeds from their sale would not be subject to tax if spent on consumption.

18.32 In determining whether or not a particular type of asset should be listed, the Meade Report suggests that

(i) listed assets should include all those items on which substantial capital gains can be made;

(ii) durable consumer goods should be unlisted, and

(iii) private houses should be listed assets.

We believe that a workable dividing line is that all assets which are chargeable assets for the purposes of capital gains tax would be listed assets, while all other assets would generally be unlisted. We have recommended in Chapter 13 that the scope of the capital gains tax be extended.

[9]The terms "listed" and "unlisted" are used to distinguish between the tax treatment given to the two types of asset. It does not mean that there would be any formal register of assets.

18.33 The most serious difficulties arise in the treatment of the following assets:

(i) Housing.

(ii) Loans.

(iii) Consumer durables.

(iv) Antiques.

Housing

18.34 We believe that a dwelling-house purchased for owner-occupation represents an important form of saving and for this reason owner-occupied houses should be treated as listed assets for expenditure tax purposes. In principle, this would require that the annual benefit arising from such assets should be included in the tax base. This would be measured by the notional expenditure which the occupier would be deemed to be making on the dwelling house. In this case notional expenditure is the same as notional income which we discussed in Chapter 10. The notional rent for the dwelling is the imputed rent on the dwelling less an allowance for repairs and maintenance. Therefore, in principle, the occupier's tax base for expenditure tax purposes should be increased by the excess of the net annual rental value of the house over the net rent paid, if any.

18.35 In dealing with the question of the base for income tax in Chapter 10, we concluded that, in principle, the imputed rental income from the occupation of housing should be charged to income tax. We decided that this should not be implemented because of the administrative difficulties involved in valuing the total national housing stock. We also felt that it would be difficult to gain public acceptance for the taxation of notional income on a general basis.

18.36 The question arises as to the weight to be given to these arguments in the context of a direct expenditure tax which would be confined to a relatively small number of taxpayers at the top of the scale of income and wealth. There was some support in submissions for the taxation of houses with a market value over a certain figure.

18.37 If houses held as business assets by private landlords and owner-occupied houses were both treated as assets which produce an actual or notional annual return respectively, it would be appropriate to treat mortgage debt as a listed liability. In this case, when a house was purchased the relief from expenditure tax on the purchase would be offset by increased expenditure tax in so far as the purchase was financed by borrowing or by the sale of listed assets; and when the house was sold the increased liability

to expenditure tax would be offset by relief from expenditure tax on the repayment of any mortgage debt (or, of course, by the relief from expenditure tax on the reinvestment of the proceeds of the sale in another house or any other registered asset). The result of this arrangement would be that the purchase of a house or the payment of interest and repayment of principal upon a mortgage debt would be deducted from the taxpayer's tax base, while the sale of a house or the raising of the principal of a mortgage debt would be added to his tax base. As is normal with a direct expenditure tax, no indexation provisions would be needed to offset the effect of inflation on the tax base.

18.38 We believe that the notional expenditure arising from the occupation of a house by the owner should not be charged to direct expenditure tax except in the case of second houses. While the administrative arguments against this are not as great as those involved in charging the notional income for income tax purposes, due to the smaller numbers involved, they are still significant. If notional expenditure is not charged, it would not be appropriate to give a deduction for mortgage interest paid.

18.39 We now examine whether or not expenditure on housing in excess of a certain limit should be treated as expenditure rather than saving. It is clear that owner-occupied houses in general must be treated as listed assets for purposes of direct expenditure tax, since investment in housing is an important form of saving. It can be questioned whether this treatment should be allowed to an unrestricted extent. One possible solution is to place a limit both for acquisition and for improvement on the amount of private house investments entitled to investment treatment and to treat outlay in excess of this limit as consumption. Such a ceiling for investment treatment would have to be adjusted in line with increases in prices.

18.40 The operation of a limit may best be illustrated by means of an example. Assume for the purposes of illustration that in year 1 the ceiling is set at £100,000. A taxpayer who in that year acquires a dwelling house for £125,000 would be entitled to a savings deduction in respect of only £100,000. In year 3 the ceiling is raised to £120,000. This increase should only apply to costs incurred after the increase in the limit of allowable expenditure was made. Thus the taxpayer would not be able to claim a deduction in respect of the expenditure of £25,000 which was disallowed at the time the house was acquired. On the other hand, he would be able to claim deductions for future improvement costs of up to £20,000 constituting the difference between the amount for which he received deductions and the new ceiling for investment deductions. Alternatively, if the threshold were indexed, expenditure incurred in earlier years should also be indexed.

18.41 Such treatment would require the apportionment of borrowing for house purchase into listed and unlisted elements. While such a procedure

adds to the complications of a direct expenditure tax, we think that it is desirable in principle and could be operated, provided the ceiling is set and maintained at a relatively high level so as to exclude the majority of expenditure taxpayers.

Loans

18.42 Under a direct expenditure tax, loans would be treated in the same way as other financial transactions. In other words, borrowing for consumption would increase the total chargeable items to expenditure tax while lending or making loan repayments would reduce it. The recipient of a loan would therefore be liable to a charge to expenditure tax on the amount borrowed unless it was used to finance investment in listed assets.

18.43 It might be desirable also to disregard certain borrowings for expenditure tax purposes on *de minimis* grounds. Such borrowings would not count as dissaving when raised but would count as expenditure when repaid. Borrowing taken into account for expenditure tax purposes would count as dissaving when raised. The whole of any repayment would then count as savings, so that the full payment (and not just the interest component) would qualify for tax relief. This would be the normal treatment of business borrowings or borrowings for the purchase of listed assets. Borrowings which might be ignored include consumer credits, borrowings on credit cards and personal borrowings for consumption purposes.

18.44 If significant borrowing were to be ignored for expenditure tax purposes, there would need to be limitations on the amounts involved which could be invested in listed assets, since this transaction would give rise to an expenditure tax credit. To the extent that this happened it would allow expenditure tax liability to be postponed indefinitely. The difficulty might be solved by putting a limit on the total amount of borrowing outstanding at any one time which would be disregarded for expenditure tax purposes and including any excess in the tax base as it was incurred.

Consumer Durables

18.45 A problem arises regarding the treatment of consumer durables under a direct expenditure tax. This has two aspects. Firstly, the acquisition of a consumer durable is an investment which is consumed over a period of several years. In principle, only that part of the investment which is consumed in any year should be taxed. One way of doing this is to grant depreciation allowances for consumer durables. This would seem to give rise to impossible administrative problems.

18.46 If the issue of the acquisition of consumer durables is considered from a practical point of view, the taxation of the whole outlay as con-

sumption in the year of acquisition causes problems only where the taxpayer's normal pattern of annual consumption is disturbed as a result of an exceptionally large purchase. If consumer durables were acquired more or less evenly every year, taxation in the year of acquisition would not cause any problems. However, this assumption is likely to be unrealistic. The more likely pattern would appear to be that consumer durables are acquired irregularly, resulting in large outlays one year and considerably lower expenditure during the next few years. The typical example is the purchase of a car or house furniture.

18.47 We believe that the problem caused by the uneven distribution of expenditure can be solved by the introduction of averaging of total expenditure on the lines recommended in Chapter 19. There are, however, other possibilities. These include ignoring certain borrowings used for consumption as suggested in paragraph 18.43 and the provision of certain types of unlisted assets which would not be regarded as savings. If the latter were drawn down this would not give rise to a tax liability. These possibilities have been explored by the Swedish Commission on Taxation.[10] In their report they establish that these methods are feasible and can be regarded either as complements to one another or as separate alternatives.

Antiques

18.48 Valuable paintings, expensive jewellery, antiques and the like have, when purchased by individuals, some of the financial attributes both of an investment and of an ordinary consumer durable. They are commonly purchased as an investment with a view to capital appreciation while, like consumer durables, they yield no money income. Therefore, it would be possible to treat these goods as either investment or consumption.

18.49 The treatment of these goods under the existing capital gains tax legislation is as follows. A gain accruing to an individual on the disposal of an asset which is tangible moveable property and not a wasting asset is exempt where the consideration does not exceed £2,000. Where the consideration exceeds £2,000, marginal relief applies to restrict the tax payable to one-half of the excess of the consideration over £2,000. Losses accruing on the disposal of such assets are restricted to the difference between cost and deemed proceeds of sale of £2,000. A wasting asset is defined as an asset with a predictable life not exceeding fifty years. The exemption does not apply to assets which have been exclusively used for the purpose of a trade or profession and have or could have qualified for capital allowances. Part use for the purpose of a trade or profession will cause part of the exemption to be lost.

---

[10]Sven — Olof Lodin. *Progressive Expenditure Tax — an alternative?* A Report of the 1972 Government Commission on Taxation, Liber Förlag, Stockholm.

18.50 To treat antiques as investments would require, in principle, that the imputed income from these assets would be charged to direct expenditure tax. This would clearly be administratively impracticable. In general, we favour the treatment of these assets as consumption goods. This means that when they are purchased, this would increase the new owner's liability to direct expenditure tax.

Assessment and Collection of Tax

18.51 The Department of Finance and the Revenue Commissioners have advised us that

> "There would be collection problems because an expenditure tax does not lend itself to a pay as you go system like PAYE. The use of estimates for a pay as you spend system would require a total review of each case at the end of the year since there is no way of knowing in advance what savings and dissavings are likely to arise in each case during the course of a year. The PAYE system would nevertheless have to be retained in full to deal with the collection of basic rate tax although this would be simplified, e.g. through the elimination of all but one of the tax tables and a reduction in the number of end of year reviews."

18.52 The problems in this area are no different to those faced in introducing a current basis of assessment for income tax purposes in the case of self-employed persons. These are that an attempt is made to collect liability on a sum the amount of which it is impossible to determine until afterwards. There are two approaches to this problem either of which could, in our view, work satisfactorily. Firstly, the liability in the case of all taxpayers could be assessed on the basis of their expenditure in a preceding year. Alternatively, liability could be based on the expenditure in the current year. This would require the institution of provisional payments with an adjustment at the end of the year. Since all taxpayers would be on the same basis no problem of equity arises. If assessment were on a preceding year basis, the only difference would be that in periods of rising prices higher rates of tax would be required to produce the same revenue yield. We favour whatever approach causes the least difficulty for both taxpayers and the Revenue Commissioners.

18.53 We consider that the PAYE system could be used to collect expenditure tax on a provisional basis from employees who are liable. It must be remembered that PAYE is a system which collects income tax on a provisional basis. Reviews are required in a significant number of cases.

18.54 As we noted in paragraph 18.22, a direct expenditure tax is only a

practicable proposition if an individual's tax liability is computed by applying the expenditure tax adjustment. This would require every taxpayer to make an annual return after the end of the tax year. The return for direct expenditure tax would be on the same form (Form 11) as the existing return for income tax purposes. The information required would be somewhat greater than that required at present. However, we do not see this causing any great problems because those liable for direct expenditure tax would, in general, be relatively sophisticated in dealing with financial matters and would generally be able to cope with the problems or be in a position to employ financial advisers to do so on their behalf.

Double Taxation Relief

18.55 Since direct expenditure tax would be levied only on individuals, the international tax implications of introducing it are confined to the personal sector. Three categories of income need to be considered:

(i) Irish income accruing to foreigners.

(ii) Foreign earnings accruing to Irish residents.

(iii) Foreign investment income accruing to Irish residents.

18.56 As far as non-residents are concerned, it would clearly be impossible to charge direct expenditure tax. No problems would arise since income payments to non-residents would suffer deduction of income tax at the basic rate and nothing else. This involves no change in existing arrangements since non-residents are not charged income tax at the higher rates.

18.57 As far as Irish residents with foreign earnings are concerned, we consider that to the extent that such income is charged to income tax it should be included in the computation of liability for expenditure tax purposes. There is no problem with overseas investment income accruing to Irish residents. The gross amount of such income (i.e. including the foreign income tax credit deducted at source) should be included in the expenditure tax adjustment. To the extent that such a credit cannot be offset against liability to income tax or social security tax, we consider that it could be credited against liability to direct expenditure tax.

Avoidance and Evasion

18.58 The scope for tax avoidance under a system in which all accretions are taxed at a single rate and expenditure is subject to a progressive direct expenditure tax is negligible compared with that which exists under a progressive income tax with separate taxes on capital gains and gifts and

inheritances. The resources which under the existing system are devoted to combatting various types of tax avoidance could be freed for other tasks.

18.59 Tax evasion can never be prevented entirely. However, the Advisory Commission on Intergovernmental Relations in the United States[11] concluded that the scope for fraud is less under a direct expenditure tax than it is with an income tax. One reason for this is that, with an expenditure tax the tax base reflects the taxpayer's standard of living. A high visible level of consumption and a low level of taxation cannot co-exist unless there is tax evasion. Under an income tax system large discrepancies may legitimately exist between assessed income and living standards.

18.60 It is sometimes asserted that tax evasion would be more profitable under an expenditure tax system than under an income tax on the grounds that unreported income can be used to acquire listed assets. It is argued that this leads to a double deduction. This is based on a misconception. Under an expenditure tax, the tax evader only escapes tax on the evaded amount. If savings are made, the tax on the declared income can be postponed, but no further scope for consumption is created as a result, since the tax is payable as soon as the taxpayer draws on his savings for consumption. To obtain this postponement of tax, increases in assets must be returned to the Revenue Commissioners and financed out of understated income. It would be very difficult to do this on a substantial scale without attracting the attention of the Revenue Commissioners to the artificially low level of expenditure.

Other Issues

18.61 A number of other issues regarding direct expenditure tax require to be settled before such a tax could be introduced. These include

(i) the tax unit;

(ii) averaging;

(iii) the treatment of emigrants and immigrants;

(iv) the treatment of gifts and bequests;

(v) the treatment of income tax payable;

(vi) the treatment of direct expenditure tax payable, and

(vii) the structure of the tax.

The Tax Unit

18.62 We recommend that the tax unit for direct expenditure tax should be the same as for all other taxes. In Chapter 15 we recommend that the family is the appropriate unit for tax purposes.

---

[11] *Advisory Commission on Intergovernmental Relations: The Expenditure Tax, Information Report*, pp. 17-84. Washington, 1974.

Averaging

18.63 The need for averaging under a direct expenditure tax levied at progressive rates is somewhat less than with a progressive income tax. This is because large expenditures are usually financed by borrowing and tax is payable only as the loan is repaid. However, we recommend that the scheme of averaging, which we recommend in Chapter 19 for income tax purposes, be applied also for the purposes of direct expenditure tax.

Emigration

18.64 If a direct expenditure tax were introduced in Ireland, Irish residents might have an incentive to save here and emigrate to spend the proceeds in countries which had relatively low taxes on expenditure. At present, Ireland has relatively high indirect taxes on expenditure and the problem already arises to some extent. For example, this occurs in the cases of artists' relief and persons in receipt of substantial amounts of dividends relieved from income tax by virtue of export sales relief. There is also avoidance of capital taxation through emigration. It has not been thought necessary to combat this form of avoidance to date.

18.65 There are two types of emigrants: temporary and permanent. Under Exchange Control Regulations a person leaving Ireland for three years or more will usually be designated as a non-resident for purposes of Exchange Control. Such persons could be regarded as permanent emigrants. A maximum of £40,000 per family unit may be exported on emigration. Assets in excess of this amount are normally blocked for a period of four years, although income earned on these assets may be transferred abroad.

18.66 We consider that if it is thought necessary to do so to prevent tax avoidance, a tax could be imposed on listed assets being exported by permanent emigrants. These could be identified through the Exchange Control procedures. We do not see any need for such a tax on persons who emigrate for a temporary period. All that would be required in these cases would be to maintain accounts of their listed assets in Ireland.

Immigration

18.67 Because a deduction would be allowed for purposes of direct expenditure tax in respect of the purchase of listed assets, it would be necessary to obtain a statement of both the listed and unlisted assets imported by immigrants. Restrictions might need to be imposed on the use of unlisted assets to acquire listed assets subsequent to immigration since otherwise immigrants could consume imported cash tax-free. It could be argued that it is desirable in the national interest to attract immigrants with

substantial resources to Ireland. If this view were taken, the need for the type of restrictions we have in mind would be avoided.

Gifts and Bequests

18.68 Gifts and bequests of listed assets could be treated as part of the donor's taxable expenditure as well as being part of the donee's expenditure when he in turn spent it or gave it away. However, we recommend that gifts and bequests should not be treated as part of the donor's taxable expenditure except for small gifts which are ignored for tax purposes in the hands of the donor. Under our proposals, such gifts and bequests would be liable to tax at the single rate in the hands of the donee. If progressive taxation of gifts and inheritances is required, this is best achieved by the imposition of a progressive tax on accessions, which is discussed in Chapter 36.

18.69 We now consider whether or not income tax and direct expenditure tax paid should be included in chargeable expenditure.

Treatment of Income Tax Payable

18.70 Income tax paid or payable could be given as a deduction from expenditure for the purposes of direct expenditure tax. However, for the following reasons we consider that income tax paid in a particular year of assessment should be treated as chargeable expenditure. Firstly, not to give a deduction for income tax paid would reduce the nominal rates of expenditure tax necessary to achieve a given degree of progressivity. Secondly, it would shift part of the burden of the tax from married to single people, which we consider desirable. Thirdly, it would reduce the complexity of the system for both the taxpayer and the Revenue Commissioners. Fourthly, it would be consistent with the treatment of other taxes, e.g. value-added tax.

Treatment of Expenditure Tax Payable

18.71 Direct expenditure tax paid or payable could also be either included or excluded from chargeable expenditure. For the reasons outlined in paragraph 18.70 in relation to income tax, we consider that all taxes paid should be included in chargeable expenditure.

Structure of the Tax

18.72 The purpose of direct expenditure tax is to achieve the desired degree of progressivity at the higher end of the scale of income and wealth. The exact numbers of individuals who should be liable to the tax and the precise degree of progressivity in the rate structure are matters for political

decision. Such decisions should also take account of the progressivity imparted to the system by selectivity in the provision of Government services.

18.73 The Revenue Commissioners have informed us that approximately 17 per cent of all income taxpayers were liable to income tax at rates in excess of the standard rate in 1981/82. Our proposals to extend the tax base, to replace income tax allowances with tax credits and to charge realised capital gains at the same rate as income will all increase the progressivity of the system. This suggests that to maintain the existing degree of progressivity in the system the number of taxpayers liable at the higher rates would have to be reduced.

18.74 It may be thought desirable that the yield from direct expenditure tax should be equivalent to the present yield from income tax at the higher rates.[12] The Revenue Commissioners informed us that the net produce of tax at these rates for 1981/82 amounted to £106 million or about 3 per cent of total tax revenue. Once the required yield is selected there are trade-offs between the maximum rate of tax, the scale of progressivity and the number of taxpayers liable.

18.75 We recommend that direct expenditure tax should be confined to individuals at the top end of the scale. This should be done by exempting annual expenditure below a certain level from the tax in the case of single and widowed persons. To comply with the requirements of the Murphy decision the tax threshold for families would have to be at least twice that level. If there is to be more than one rate of direct expenditure tax, double rate bands would have to be provided for families. No further differentiation would be required for other dependency obligations if these are taken fully into account in fixing the relative amount of tax credits for income tax purposes. To the extent that these credits cannot be set off against income tax or social security tax payable, the balance should be offset against liability for direct expenditure tax. However, we recognise that there is likely to be strong public feeling on the equity of taxing married couples without children and those with children to the same amount of expenditure tax. To take account of this view and to make the proposed tax more acceptable, we recommend an additional credit/threshold in respect of children to apply for purposes of direct expenditure tax only.

18.76 We consider that the number of different rate bands should be kept reasonably low, since a proliferation of different rates of tax increases administrative complexity. We think that the number of rates should not

[12] This refers to the yield from the excess of the higher rates of tax over the standard rate.

exceed three. To reduce the number of cases in which averaging is required the rate bands should be as wide as possible.

18.77 There is insufficient data on which to base detailed estimates of the yield of a direct expenditure tax compared with an income tax at the same rates. Such evidence as there is suggests that the total tax base would be somewhat larger or, in any event, not smaller than the existing income tax base, unless there were considerable changes in the consumption behaviour of households. For example, total personal expenditure as estimated in the National Accounts for 1978 was £4,823 million. This is 40 per cent greater than gross income of £3,443 million charged to tax in 1978/79 as shown in the Annual Report of the Revenue Commissioners.[13] On the other hand, there is no basis for exact calculations of the tax base by income range. However, we are confident that because the existing income tax base is so narrow, the yield from a single rate income tax and a progressive direct expenditure tax will be sufficient to replace the revenue at present raised from income tax.

18.78 We consider that our proposals to widen the income tax base and to introduce a direct expenditure tax at the higher end of the scale of income and wealth must result in the vast majority of taxpayers being liable at a combined income tax and social security tax rate below the current standard rate of income tax of 35 per cent. The direct expenditure tax must apply to a much smaller number of taxpayers than are now liable to income tax or the higher rates. At present, the income tax base is very narrow and nominal rates of tax are very high. We consider that lower rates of tax should be levied on a base defined by reference to a wider definition of income. However, the ultimate choice of the rates and thresholds of direct expenditure tax is a matter for political decision.

Transitional Arrangements

18.79 The transitional arrangements for the introduction of a direct expenditure tax are outlined in Chapter 38.

Recommendations

18.80 We make the following recommendations:

1. Income tax at the higher rates should be replaced by a direct expenditure tax operated on the "expenditure adjustment method" outlined in paragraph 18.22.
2. Deductions for saving should be given in respect of increases in listed assets or decreases in borrowings.

[13] 57th Report, Prl. 9519 Table 75.

3. Housing should be treated as a listed asset.

4. It is desirable that a ceiling be imposed on the amount of housing which would qualify as a listed asset. This ceiling should be fixed and maintained at a relatively high level so as to exclude the majority of individuals liable to direct expenditure tax.

5. Certain borrowings such as consumer credits and personal borrowings for consumption purposes might be ignored on *de minimis* grounds. In these circumstances, there would have to be limitations on the amounts of such borrowings which could be invested in listed assets.

6. Expenditure on antiques should be treated as consumption.

7. Direct expenditure tax could be charged on either a current or preceding year basis of assessment. We favour the basis which causes the least difficulty for both taxpayers and the Revenue Commissioners.

8. The tax unit for direct expenditure tax should be the same as for all other taxes.

9. A system of averaging as outlined in Chapter 19 should be available.

10. Gifts and bequests of listed assets should not be treated as part of the donor's taxable expenditure.

11. Both income tax and expenditure tax paid should be treated as chargeable expenditure.

12. To the extent that credits, recommended in Chapter 16 cannot be set off against liability to income tax or social security tax, they should be set off against liability to direct expenditure tax.

13. The exemption threshold for direct expenditure tax in the case of families should be at least double that provided in other cases.

14. An additional credit/threshold should be provided in respect of children for purposes of direct expenditure tax only.

15. In the event of there being different rates of direct expenditure tax, double rate bands should be provided for families. However, the number of rates should not exceed three.

CHAPTER 19

AVERAGING

Introduction

19.1 We now examine the case for averaging under a system in which income or expenditure is taxed on an annual basis at progressive rates. We conclude that the provision of a system of averaging of general application is essential if there is progressive taxation. During the transition to a single rate of income tax, a system of income averaging is needed if the income tax base is to be extended on the lines we propose.

The Problem

19.2 We noted earlier that the application of progressive rates to a comprehensive tax base on an annual basis causes problems. The existence of a statutory income tax year, coupled with a progressive structure of income tax, results in a higher tax burden on fluctuating incomes than on an equal amount of income accruing evenly over the years. The steeper the degree of progression, the greater is the penalty for having income "bunched" in time and the greater is the need for a system of averaging. A progressive income tax levied on a strictly annual basis has an inevitable bias against occupations with fluctuating earnings and those which carry a high income for a relatively short number of years.

Principles

19.3 We have defined the tax base as the amount which may be spent on consumption in a period while maintaining real capital intact. Such a definition represents the taxpayer's increased command over economic resources in the period. On this basis, it is clear that if we take a number of consecutive periods, the total tax liability in real terms should be the same over those periods if the increase in command over real resources is the same, regardless of the distribution of the income between the periods. Therefore, in principle, a system of averaging is required.

Background

19.4 For many years, both in Ireland and the United Kingdom, trading and professional incomes were averaged on a three-year basis but because

of the complications and other difficulties to which it gave rise, the system was not favoured by taxpayers and it was abandoned in Ireland as from 1930/31, having been abolished in the United Kingdom some years earlier.

19.5 The question of averaging was considered by the Commission on Income Taxation which recommended that

> "When a person's total income for any year is less by at least 30 per cent than his total income for the previous year he may have the income of the two years averaged for sur-tax".[1]

19.6 Under the present tax code, there is a limited degree of averaging permitted under the provisions which allow carry-forward and carry-back of trading losses against income. Capital allowances may also be carried forward and losses arising on cessation of a trade may, with some restrictions, be allowed against the trading income of the preceding three years.

Averaging for Farmers

19.7 With effect from 1981/82, a system of averaging was introduced for the taxation of farming profits. The new averaging rules apply only to certain individual farmers and not to others. Farmers may opt for averaging unless

(i) the farmer or spouse carries on another trade or profession in partnership, or otherwise, or

(ii) the farmer or spouse is a director of a company carrying on a trade or profession provided he or she directly or indirectly controls more than 25 per cent of the issued share capital of the company.

19.8 Averaging enables a farmer's profits for tax purposes to be computed by reference to his average profits or losses for the three preceding years. Where an election for averaging is made, it remains in force until the individual either ceases to be a qualifying farmer or opts out of the system. An election for averaging may be made only where the farmer was charged to tax on the preceding year basis for the two years prior to the year for which the election is made. A farmer may opt out of averaging only if he was charged to tax on the average basis for each of the three years of assessment immediately preceding the year for which he wishes to revert to the normal basis. If he wishes to revert to the normal basis of assessment, the assessments for each of the two years prior to the last year based on averaging are reviewed. If the existing assessment for either or both of these years is less than the assessment for the last average year, an additional assessment for the difference is made. Where the farmer completely ceases

[1]Seventh Report paragraph 522.

farming, the normal cessation provisions are applied, irrespective of an election for averaging basis.

19.9 The operation of income averaging in the case of farmers is best explained by an example.

Example: A farmer's accounts as adjusted for tax purposes show the following results:

		£
Year ended	31 December, 1979	6,600
.. ..	31 December, 1980	7,200
.. ..	31 December, 1981	8,400

In the normal way, the farmer's profits for income tax purposes for 1982/83 would be treated as equal to the adjusted profit for 1981, that is £8,400. Under the averaging provisions, the farmer is now given the option of having the 1982/83 assessment based on the average adjusted profit for 1979, 1980 and 1981. If averaging is opted for, the assessment for 1982/83 will be reduced to £7,400.

19.10 Averaging was introduced for farmers because of the cyclical nature of farming. However, the system may be applied in situations in which the profits are not cyclical and it provides a benefit to farmers in such instances. This may be shown as follows. Assume that a farmer and a shopkeeper each earn the same income over a ten year period 1980-89 in the manner set out in Table 25. Assume also that income rises at a rate of 10 per cent per year and that both begin trading at the beginning of 1980 and cease to trade at the end of 1989.

TABLE 25

Hypothetical Incomes of Farmer and Shopkeeper

Year Ended	Farmer	Shopkeeper
	£	£
31 December, 1980	10,000	10,000
,, 1981	11,000	11,000
,, 1982	12,100	12,100
,, 1983	13,310	13,310
,, 1984	14,641	14,641
,, 1985	16,105	16,105
,, 1986	17,716	17,716
,, 1987	19,487	19,487
,, 1988	21,436	21,436
,, 1989	23,579	23,579
	159,374	159,374

19.11 The assessments will be as shown in Table 26 if the farmer opts for

averaging for 1983/84 (the earliest year for which he may do so) and subsequent years.

TABLE 26

Comparison of Tax Treatment of Farmer and Shopkeeper with Equal Incomes

Year of Assessment	Income for tax purposes	
	Farmer	Shopkeeper
	£	£
1979/80	2,500	2,500
1980/81	10,000	10,000
1981/82	10,000	10,000
1982/83	11,000	11,000
1983/84	11,033	12,100
1984/85	12,137	13,310
1985/86	13,350	14,641
1986/87	14,685	16,105
1987/88	19,487	19,487
1988/89	21,436	21,436
1989/90	17,684	17,684
Total	143,312	148,263

19.12 Table 26 shows that, for the four years (1983/84 to 1986/87) for which the farmer may claim averaging, the amount of income for which the shopkeeper is assessed to tax is 9.7 per cent more than the income on which the farmer is assessed, even though the earnings profile is identical. Due to the progressivity of the tax system, the difference in tax payable would be substantially greater than this. This arises because, when the rate of increase in income is regular, averaging effectively results in farmers being assessed for the current year on the amount of nominal income earned over two years ago. On this basis, we conclude that the existing system for farmers requires amendment.

Systems of Averaging

19.13 Any scheme of averaging is necessarily complicated. However, these complications are necessary in order to combine progression and equity in taxation. In principle, the fairest method of averaging is lifetime averaging.[2] Theoretically, this could be done by applying a cumulative system as in PAYE, not merely over a year's income as it accrued week by week, but over a lifetime's income as it accrued year by year. Thus, each year cumulative totals would be made of the total income which the taxpayer had received and for the total tax which he had paid over his whole life to date. A calculation could then be made of the tax which would have been paid if each year the total income was spread evenly over his life to

[2]W. Vickrey, 1947 *Agenda for Progressive Taxation*. Chap. 16.

date. The taxpayer would then be liable to pay additional tax or receive a rebate equal to the excess or deficiency of this calculated lifetime tax liability over the total tax actually paid to date. Such a system would be impracticable in present circumstances. The following methods of averaging would appear to be workable.

Tax Reserve Certificates

19.14 The first method is to allow individuals to purchase tax reserve certificates, the purchases of which would be deductible for tax purposes and the sales of which would be added to taxable income. There would be no limit on these purchases. This would enable a taxpayer to average forward over time and would help people with very high current incomes which were expected to be only temporary. No interest would be payable on the tax reserve certificates but they would be indexed. If interest were payable, it would enable taxpayers to save tax-free even if their incomes did not fluctuate.

Block Averaging

19.15 The second method is to allow individuals to average backwards by a system of "block averaging". In any year an individual could elect to spread his current income (or expenditure) over both the current year and a sequence of preceding years, subject to the following constraints:

(i) The averaging period must consist of consecutive years.

(ii) There is a limit on the number of years to be used (e.g. five).

(iii) Once a year has been used in an averaging calculation it cannot be used again.

19.16 The operation of this system may be illustrated by an example. In the years 1977/78 to 1980/81 the individual pays tax on his current income. In 1981/82, he earns an unusually large sum of £20,000, so he elects to average. The £20,000 earned in 1981/82 may be divided in any way subject to the above constraints. Given the tax rates and allowances for each year, the total liability for each year is calculated and the difference between the new liability and the amount paid in the past is collected. The system would operate as follows:

Year	Original Income	Amount Allocated	Income after Averaging
	£	£	£
1977/78	3,000	+ 4,000	7,000
1978/79	4,000	+ 3,000	7,000
1979/80	5,000	+ 3,000	8,000
1980/81	9,000	NIL	9,000
1981/82	20,000	−10,000	10,000
Totals	41,000		41,000

19.17 Although this scheme is administratively feasible, it is unsatisfactory in that relief may be long delayed. A taxpayer may have to wait for up to five years before a refund is received.

United States System

19.18 The United States system is a further possibility. This is available to all taxpayers whose current year income is in excess of 120 per cent of their annual average income of the base period (generally four years), provided that the excess is greater than US$ 3,000. The system is based on the moving average principle. The steps for computing current year tax liability are set out in Appendix 15.

19.19 A variant of this system also applies in Canada. Such a scheme tends to reduce tax liability when income is rising. When income is falling averaging does not apply. Furthermore, the eligibility tests go some way towards excluding those taxpayers whose income instability is caused purely by inflation. However, the system is extremely complicated and taxpayers would find it difficult to understand.

Recommended System

19.20 In general, we believe that the present system of averaging which applies to farmers provides a suitable model for a general system of averaging. However, the present system requires amendment in the following areas:

(i) Persons to whom it applies (the scope of the provisions);

(ii) Length of the averaging period, and

(iii) Adjustment for inflation.

Scope of Averaging Provisions

19.21 Averaging is necessary to provide equity between persons whose real income (or expenditure) fluctuates and those who receive the same aggregate income (or expenditure) in real terms spread evenly over time. For this reason, we consider that there is no justification for confining averaging to particular occupations or sectors. Therefore, we recommend that a system of averaging be made available generally.

19.22 The starting point for averaging would be the first full year in which a particular tax unit came into being. Thus, individuals would not be entitled to include in the averaging period years when they were dependants and had no taxable income. Similarly, recently married couples

opting for joint assessment would not be entitled to include in the averaging period years when they were single and taxable at higher rates.

Length of the Averaging Period

19.23 In principle, the averaging period should be as long as possible. However, administrative considerations mean that lifetime averaging is impossible. On the other hand, the existing period of three years is too short. It does little to help those who may experience high earnings for a short number of years. A compromise between the demands of equity and administration might be a period of six years.

Adjustment for Inflation

19.24 All taxpayers experience some fluctuations in income and during periods of rapid inflation the rise in the income of average taxpayers can be quite marked when expressed in money terms. For example, the earnings of the average industrial worker in Ireland[1] rose as follows in recent years:

	£
1975	2,386
1976	2,801
1977	3,300
1978	3,774
1979	4,450
1980	5,008

These figures show that average money earnings in 1980 were nearly 50 per cent greater than average income over the preceding five year period.

19.25 Averaging of income (or expenditure) should only take account of fluctuations in real income (or expenditure). To do this it is necessary to gross up the income for all years in the averaging period by the rise in the Consumer Price Index in the intervening years. In principle, the multipliers should be based on the average increase in the Consumer Price Index over the four quarters. This would require the publication of a table of multipliers as is done at present for purposes of capital gains tax.

19.26 This system of averaging would work as follows. The industrial worker (see paragraph 19.24) who opted for averaging in 1979/80 would have his average income for the previous five year period calculated as follows:

[1] Based on September 1981 quarter returns of Census of Industrial Production for transportable goods industries.

Year	Actual Income	Multiplier	Adjusted Income
	£		£
1979/80	4,450	1.000	4,450
1978/79	3,774	1.109	4,185
1977/78	3,300	1.300	3,960
1976/77	2,801	1.400	3,921
1975/76	2,386	1.625	3,877
			20,393

$$\text{Averaged income} = \frac{20{,}393}{5} = £4{,}079$$

19.27 It may be felt that this system is too complicated to work satisfactorily. We accept that the calculation may appear to be complicated. However, the principles underlying it are relatively simple. Since the assessment and collection of tax now relies heavily on computers, we do not consider that the relative complexity of the system which we have recommended would cause undue administrative difficulty.

19.28 For ease of administration it may be necessary to confine averaging to those taxpayers who experience substantial fluctuations in real income. This could be done by confining the option to average to those whose income in real terms, after averaging, differs by more than a specified percentage from the income for the year for which averaging is claimed. However, if the bands of taxable income or expenditure are reasonably wide a restriction on these lines is unlikely to be necessary.

19.29 The Revenue Commissioners drew our attention to some difficulties arising from applying an inflation adjustment in cases in which a taxpayer's income may derive from various sources not all of which would be assessed on the same basis so that different percentages would have to be applied to each. For example, an individual's income might consist of

(i) business profits assessed on the basis of a set of accounts which could be made up to any date within a one-year period prior to the year of assessment;

(ii) profit rents assessed on the basis of the amounts arising in the year ended on the previous 5 April, and

(iii) directors' fees assessed on an actual basis.

This difficulty merely reinforces the case for all income to be charged to tax

on a current basis which we recommend later in this report. It also emphasises the merits of charging all income at a single rate of tax.

Recommendations

19.30 We recommend that under any system of progressive taxation:

1. An averaging system of general application on the moving average principle should be provided.
2. The averaging period should be at least six years.
3. The starting point for averaging should be the first full year in which a particular tax unit was in existence.
4. Averaging should be confined to fluctuations in real income or expenditure determined by reference to the Consumer Price Index.

CHAPTER 20

INDEXATION OF PERSONAL TAXATION

Introduction

20.1 In this chapter we recommend that income tax allowances or credits and bands of taxable income be indexed annually. We further recommend that the index to be used for this purpose should be the Consumer Price Index. This does not mean the Government would be committed irrevocably to unchanged income taxes in real terms. Indexation is purely a technical procedure to ensure that consideration of changes in taxation takes, as its starting point, the indexed tax structure. The Government would retain full discretion over tax changes. However, any changes would have to be explicit and be shown by reference to the indexed position.

20.2 Arguments sometimes advanced against the indexation of personal taxation are that it reduces the built-in stability of the economic system and may produce a general public impression that the Government accepts that inflation will continue and, consequently, may increase inflationary expectations that may become self-fulfilling. A related argument concentrates on the psychological reaction of Governments to the introduction of indexation, in that it may result in a lower urgency being given to controlling inflation because of the belief that the personal taxpayer is more or less immune from the detrimental effects of inflation. As a result, inflation may be made more tolerable. We consider these arguments in the following paragraphs.

Automatic Stability

20.3 The tendency for progressive personal taxation to produce a more than proportionate increase in personal tax revenues has been thought to contribute to the built-in stability of the economic system. Rising money incomes have been regarded as a symptom of an increasing pressure of demand on available resources. Automatic increases in tax rates, by reducing personal disposable incomes (in real terms), reduce the demand for output in the market sector, thereby helping to eliminate excess demand. This analysis assumes that the additional tax revenue will not be used to increase Government spending.

20.4 There are a number of objections to this view. Firstly, in recent years the acceleration in the rate of inflation has removed the earlier illusion of taxpayers that unchanged income tax allowances and bands of taxable income implied that real tax burdens were stable. This increased public awareness has led to reactions, mainly in the form of resistance to higher taxation, that tended to exacerbate both inflation and unemployment. This led to a tendency towards bargaining in terms of take-home pay which tended to ignore the benefits of increased Government expenditure. This matter is discussed in Appendix 4.

20.5 Secondly, the proposition concerning the automatic stabilising properties of a progressive income tax only applies when inflation is due to excess demand. The stabilising properties of income tax operate perversely if the inflation is of the "cost-push" variety or is due to a rise in the price of imports. There is no evidence to suggest that inflation in Ireland is attributable only to excess demand.

20.6 In Ireland, whatever stablising properties an unindexed system possesses are rendered ineffective by the non-application of the second assumption underlying the proposition: that additional tax revenues produced are frozen. It has not been the practice in Ireland to restrain public expenditure in the light of increased tax revenue. In fact, the evidence suggests that the growth in income tax revenue arising from real tax rate increases has facilitated the growth in public expenditure.

Inflationary Expectations

20.7 It may be argued that adjustment of the tax system for the effects of inflation would increase inflationary expectations by signifying acceptance by Government of continuing high inflation. This argument carries little weight. Expectations are generally a reflection of recent experience. As a result, it is likely that the public in Ireland anticipate a high and continuing level of inflation. To the extent that the public perceives that the Government has a vested interest in inflation in the absence of indexation, the adoption of indexation would reduce inflationary expectations. We believe that this perception is widespread and justified.

20.8 Without indexation, discretionary cuts in taxation, which are represented as budget giveaways, merely offset the encroachment of fiscal drag. In recent years, some Ministers for Finance have claimed that they were making considerable tax concessions when they were in reality sanctioning increases in income tax that had occurred due to inflation.

Effect on Public Finances

20.9 In analysing changes in the rate of Government expenditure, it is important to distinguish between growth in real and money income. When changes in real income take place, it is necessary to allow for the fact that measured growth in productivity is less in the public sector than in the private sector. In part this is because it is usually possible to observe only the cost of Government services rather than their value to consumers. However, it is still likely that productivity growth in the public sector would be lower because the growth in capital goods per employee is low. Given that wages in the two sectors tend to move in line with each other, an unchanged share of the public sector in gross domestic product at constant prices implies an increased share at current prices.

20.10 If the analysis is confined to purely nominal increases in income, however, the question is whether inflation is likely to result automatically in a proportionate increase in Government expenditure which is less than, equal to, or greater than the automatic increase in revenue. On the assumption that inflation in Ireland is not proceeding at a faster rate than in competing countries, the prices of goods purchased by the Government are likely to increase roughly in line with the rate of inflation. Also, public sector wages, salaries and pensions may be expected to move roughly in line with increases in private sector wages and salaries.[1] Not all transfer payments and subsidies are subject to prompt adjustment and the real cost of servicing internal borrowing is likely to decline unless interest rates adjust fully for increases in the rate of inflation. Therefore, it is unlikely that Government expenditure increases more than proportionately to the rate of inflation. It may be argued that Government expenditure is heavily concentrated on services and will rise more rapidly than prices in general. If inflation does cause an increase in the relative price of labour, this conclusion is valid but it is not obvious that inflation of itself results in this. So long as labour costs and interest charges adjust similarly to the rate of inflation, the relative price of labour to capital remains unchanged.

20.11 When inflation accelerates it is clear that a major benefit to Government arises in the form of an erosion of the value of long-term fixed interest securities. As a major domestic borrower it benefits in the same manner as

[1]See *Report of the Committee on Costs and Competitiveness*, Prl. 154, September 1981, paragraph 2.15 et seq.

"income in public administration has not kept pace with that in manufacturing or in services over the period since 1970. The relative decline in public administration incomes was most marked over the period 1975-77, since when there has been some recovery."

other borrowers until interest rates adjust fully to take account of the higher rate of inflation. Because of the long-term nature of much of Government borrowing, this is a long-term benefit.

20.12 The Department of Finance informed us that total tax revenue in Ireland increases roughly in line with the rate of inflation, provided there is no indexation. For these reasons, we believe that inflation has a favourable short-term effect on the public finances when there is no indexation. To the extent that adjustment of the tax system for inflation would remove these benefits, we believe that this would strengthen rather than reduce the resolve to reduce inflation.

20.13 Indexation does not imply that the relative tax burdens fixed in a base year are sacrosanct and cannot be changed. It takes any legislated tax structure and maintains its relative burdens until explicitly altered by Government. It does not and is not intended to tie Government to a fixed distribution of the tax burden for all time. On the contrary, it provides Government with more rather than less control over that distribution. However, it is true that indexation implies that Government must consider and explicitly justify any departure from the original distribution. This we regard as wholly desirable.

20.14 We noted earlier that inflation increases average rates of income tax under a progressive system by different proportions for individuals at different levels of income and for individuals having the same income but different dependency obligations. If the distribution of taxation originally decided on by the Oireachtas is accepted as being fair and inflation alters the tax burden in an arbitrary fashion, we believe there is a clear case on grounds of equity to have indexation to restore the original distribution of taxation.

20.15 The Department of Finance and the Revenue Commissioners submitted that one of the arguments against indexation was that

> "the restrictive effect of indexation on the yield of income tax would seriously limit Governments' ability to adapt taxation policies to prevailing social and other objectives".

This argument implies that it is politically easier to make changes in the distribution of taxation by stealth rather than having to justify them openly. We agree. However, we consider that this is a telling argument for indexation. In a democracy, transparency is to be welcomed unreservedly.

Technical Problems

20.16 When the principle of indexing the personal tax system is agreed, a number of technical issues remain to be decided. These concern (i) the

choice of index, (ii) the treatment of the effect of indirect taxes and subsidies on the index, (iii) the treatment of changes in prices resulting from fluctuations in the terms of trade and (iv) the question of the timing of adjustments.

The Choice of Index

20.17 As long as inflation continues there will be a need to adjust allowances and the progressive rate scales of all taxes and specific excise duties. It is necessary to consider what is the best general price index or indices to use for indexation purposes. Any index should satisfy four tests. Firstly, it should be a good measure of inflation; secondly, it should be generally accepted as a measure of the rate of inflation; thirdly, it should be readily available; finally, it should not be subject to retrospective revision.

The Case for a General Index

20.18 It may be argued that no single figure can reflect changes in real incomes of groups with different expenditure patterns. For example, in a period in which food prices are rising in relation to other prices, the lower income groups may be more severely affected by inflation than other groups. The use of differentiated price indices for purposes of indexation would require the nominal values of allowances to be different for each income group (and at the theoretical extreme to be different for each person). This would be administratively impossible. The only feasible solution is to use a general index. If it is desired to compensate certain groups for relative price changes, separate discretionary measures are the only practicable method of doing so.

The Price of Gross Domestic Product at Factor Cost

20.19 We have considered whether the price of gross domestic product at factor cost should be the index used. This index, unlike the Consumer Price Index, excludes both indirect taxes and subsidies from the prices of the goods and services covered and also refers only to domestically produced goods and services. Hence it may provide a better measure of changes in the real income of the nation than the Consumer Price Index. However, it differs in two further important respects from the Consumer Price Index in that it covers, in addition to the prices of goods and services bought by individuals for their personal consumption, also (i) the prices of goods (e.g. plant and machinery) bought for the purposes of capital investment and (ii) the prices of goods and services (e.g. the services of civil servants) bought by the Government for public use. Thus a fall in the real value of indirect taxes, a reduction in the price of imports relative to home-produced goods, a rise in the price of capital goods relative to consumption goods or a rise in the price of goods and services bought by the Government relative to the price of goods and services bought for private consumption would cause

the price of gross domestic product at factor cost to rise faster than the Consumer Price Index.

20.20 Denison[2] argues that the purpose of indexing the income tax structure is to prevent a change in the general price level from changing the ratio of income taxes to the value of the nation's income. Given real income, the ratio of income tax revenues to income measured in current prices is to be the same whatever the price level. In other words, the purpose of indexation is to make the real tax on a given real income the same. However, "real income" should refer to the nation's real income rather than to that of individual taxpayers since the latter interpretation would require different indices for each taxpayer because each taxpayer has a unique pattern of consumption. The correct index is the one which corresponds most closely to the definition of income for tax purposes.

20.21 There are a number of objections in practice to the use of the price of gross domestic product at factor cost as an index for purposes of indexation. Firstly, the index is not published by the Central Statistics Office until about eighteen months after the end of the year to which it relates. Secondly, the estimates of the index are subject to frequent subsequent revision. Many of these revisions are substantial. This consideration alone would make the use of this index administratively impossible. Finally, we think that it would be very difficult for the public to understand what is involved in the use of this index. For this reason, it is likely to be less acceptable than the Consumer Price Index which is more easily understood.

Index of Average Earnings

20.22 We have also considered the use of an index of average earnings for the purposes of indexation of personal income tax. The use of an index of the price of finished products will remove monetary fiscal drag but it will not remove real fiscal drag. There may also be social reasons for thinking of many of the allowances and bands of taxable income in relative terms, that is, as properly bearing a certain relationship to average earnings. On the other hand, an earnings index would only be based on the earnings of employees who form only a part, albeit a substantial one, of the population. An index based on average earnings would, therefore, be affected by changes in the relative share of employees in national income. This would not be wholly desirable. At present in Ireland, there is no index of average earnings. The indices that are available refer to the earnings of industrial workers.

Consumer Price Index

20.23 We believe that the main purpose of indexation is to maintain the distribution of taxation between individuals with different real income

[2] E.F. Denison "Price Series Indexing the Income Tax System" in *Inflation and the Income Tax*, Henry J. Aaron Editor, The Brookings Institution, 1976.

levels and different family obligations until this is explicitly changed by the Oireachtas. To be consistent with the concept of income which we have adopted as "the increase in the command over goods and services for personal satisfaction", an index is required which measures real purchasing power in the hands of consumers. This suggests that the most appropriate index for purposes of indexation is the Consumer Price Index.

20.24 All countries[3] which currently adjust their personal income tax structure for the effects of inflation measure inflation by reference to an index of consumer prices. In addition to measuring real purchasing power in the hands of consumers, the Consumer Price Index also meets the three tests which are required for a satisfactory index. It is generally accepted by the public as a measure of the rate of inflation; it is made available on a quarterly basis — the figure is published five weeks after the date of the survey—and it is not subsequently revised. We recommend that all personal tax allowances, credits and bands of taxable income be automatically adjusted each year in line with changes in the Consumer Price Index.

The Effect of Indirect Taxes and Subsidies

20.25 We have recommended that indexation should be based on changes in the Consumer Price Index. Consumer price indices reflect both changes in indirect taxes and consumer subsidies. There are two main arguments for removing the price effects of discretionary changes in indirect taxation from the index used to adjust the personal tax system. Firstly, it is argued that where an increase in indirect taxes produces additional Government revenues which are used to increase public expenditure, the reduction in real private disposable income of taxpayers is compensated for by an increased supply of public goods — the "social wage". However, if this view is accepted there is no need for indexation at all since real income remains the same. All that changes is the relative proportion of public and private goods and services which taxpayers can command. The weakness in this argument is that there is no clear relationship between the distribution of the benefits of Government expenditure and the distribution of the tax burden. In fact, most modern fiscal systems reject the notion that taxation is levied on the basis of the benefit principle.

20.26 Secondly, it may be argued that if indirect taxes are increased as part of a policy to transfer real resources to the public sector, it would frustrate the objective of the tax increase to compensate taxpayers for the resulting price increases through full indexation of the income tax. If this

[3]The countries which have introduced schemes to adjust the income tax code for inflation include Iceland, France, Luxembourg, Denmark, Netherlands, Canada, Australia, United Kingdom and Sweden.

argument is valid, it is not clear why it should be confined to indirect taxation and not applied, for example, also to changes in company taxation. The logical extension of the argument is that the component of total inflation caused by Government policies designed to shift resources from the private to the public sector should not be included in the index. This would include not only price movements attributable to changes in all forms of taxation, but also any price increases generated by increased Government borrowing or by increases in the money supply generated to finance budget deficits.

20.27 If it is desired to transfer resources to the public sector through the medium of indirect taxation, the increase in indirect taxation can be such as to take account of the loss of revenue arising from the use of an unadjusted index for indexation purposes. If the effect of indirect taxes is excluded from the index, the reduction in prices arising from an increase in consumer subsidies should also be disregarded. This is unlikely to be acceptable to Government.

20.28 We have been advised that, prior to the adoption of indexation of personal allowances and bands of taxable income in the United Kingdom, consideration was given to the use of an index which would exclude the price effects of indirect taxation. The idea was rejected on the grounds that it would probably prove unacceptable to the public.

Changes in Prices Resulting from Changes in the Terms of Trade

20.29 If the terms of trade move against a country — the increases in oil prices in recent years provide a good example of this — then, if the balance of payments is not to deteriorate, a net transfer of real resources abroad must be made. Therefore, the nation's command over resources is reduced. For this reason, it is argued that it is wrong to compensate taxpayers for a rise in prices which is due to a fall in real national income. When movements in the terms of trade are favourable, the converse argument presumably would apply.

20.30 If the index used to adjust income tax rates and allowances were less than the rate of price increases (as it would be if the Consumer Price Index were adjusted for an adverse movement in the terms of trade) then an arbitrary redistribution of the tax burden would take place. This would be identical to the redistribution that would take place under an unindexed system if the actual rate of inflation were equal to the rise in prices imputed to the change in the terms of trade. An increase in import prices may require that there be a decline in real living standards. This may imply that nominal income cannot be adjusted fully to compensate for increases in import prices. However, it is not necessary from the point of view of equity that reductions in real income arising from increased import prices

are accompanied automatically by a real increase in personal taxation and by a redistribution of the tax burden between different real income levels and dependent categories. Any such redistribution may hit low income taxpayers with large families relatively hard.

20.31 It would not be practicable to adjust the Consumer Price Index for changes in the terms of trade. We have been advised by the Central Statistics Office that they "would not be in a position to make an estimate of the overall changes in consumer prices attributable to changes in the terms of trade as any such estimate would of its nature be arbitrary".[4]

Timing of Adjustments

20.32 Time lags have important implications for personal tax indexation schemes. The most common type of indexation scheme involves the adjustment of income tax rates and allowances at the start of a tax year in line with the rate of inflation during the previous tax year. For example, in Canada the index refers to the rise in prices for the twelve months up to the previous September. One possible method is to adjust income tax allowances and rates at the beginning of a tax year in line with the forecast rates of inflation for the year. The Government could be reluctant to use forecast rates of inflation for adjustment purposes because to do so they would have to make public their own expectation about the course of inflation during the coming year. In order not to stimulate inflationary expectations, there would be a strong temptation to use an adjustment rate lower than the forecast rate. The adjustment for the following year would have to take account of any discrepancy between the forecast and the actual rates of inflation in the preceding year.

20.33 In practice, the most satisfactory method is probably to adjust for inflation during the preceding year. In Irish circumstances, this would mean that the adjustment factor for the income tax year 1982/83 would be announced in the 1982 budget and would be normally based on the rate of inflation in the twelve months to mid-November, 1981. Should the Consumer Price Index be prepared on a monthly basis, the latest available period of twelve months should be used for indexation purposes.

Implications for Budgetary Policy

20.34 The case for indexing the personal income tax rests on two powerful arguments. Firstly, it would reduce or remove most of the serious inequities which arise when rapidly increasing levels of prices and money incomes are

[4]Agreed note of meeting with representatives of the Central Statistics Office held on 18 February, 1981.

combined with a progressive tax structure. Secondly, it would reduce the importance of inappropriate fiscal drag which has seriously eroded parliamentary control over budgetary policy.

20.35 Indexation of personal income tax involves an undertaking by the Government that inflation will not be allowed automatically to change the distribution of taxation from that originally approved by the Oireachtas. It ensures that changes in the distribution of taxation will be subject to proper parliamentary and public debate. Government will retain the right to make discretionary adjustments to the personal tax system but these should be made explicitly by reference to the indexed position. Spurious claims of tax savings by reference to the unindexed position should be avoided.

Recommendations

20.36 We make the following recommendations:

1. The monetary amounts of all personal tax allowances or credits and bands of taxable income should be adjusted each year by reference to the change in the Consumer Price Index over the previous period of twelve months.
2. If it is necessary for administrative reasons to do so, monetary amounts should be rounded upwards.
3. To aid public understanding of the effects of inflation, the gains or losses arising from discretionary changes in income tax rates and allowances or credits should be shown by reference to the indexed position.

CHAPTER 21

SOCIAL INSURANCE CONTRIBUTIONS

Introduction

21.1 In this chapter we consider the place of social insurance contributions in the tax system. We examine the nature of these contributions in Ireland and a majority of us concludes that they are a form of taxation and that it is appropriate to evaluate them by the criteria of equity, efficiency and simplicity which we have applied to taxation. On evaluating the existing contributions by reference to these criteria, we find them to be regressive and inequitable, to have undesirable economic consequences and to be administratively cumbersome. Most of us recommend the replacement of social insurance contributions with a social security tax assessed and collected on the same basis as income tax. This would imply that the employers' contribution would be based on profits rather than payroll, while employees' contributions would be a proportion of all income (without a ceiling). This would make social security taxation indistinguishable in its incidence and administration from other direct taxes on income. However, we do suggest continuing conceptual distinctions between these taxes.

21.2 We received a number of submissions which dealt with social insurance contributions. The main points raised were that the contributions should be reduced to encourage job creation; the employer's share should be increased; contributions should be allowed as a deduction for income tax purposes; contributions should be paid by all groups at a uniform rate on all income without a limit on the amount of contribution; and social insurance contributions should be abolished and replaced by general tax measures.

Definition of Social Security

21.3 There is no universally accepted definition of social security. In Ireland, it is generally understood to include the social insurance scheme,[1]

[1]The main social insurance benefits are: retirement pension, disability benefit, unemployment and pay-related benefits, maternity benefit, contributory old age and contributory widow's pensions.

the social assistance system,[2] health services and the redundancy payments scheme. In each of these areas the basis of qualification for benefit is quite different. Entitlement to social insurance is based on a record of contributions previously paid into the scheme. Entitlement to social assistance is on the basis of a means test. Lump sum payments are paid to certain insured workers who lose their jobs through redundancy, provided certain requirements are met. The lump sum is related to years of service and subject to an earnings ceiling. We deal with entitlement to health services in Chapter 22.

21.4 A brief description of the social security system, its historical development and its financing is set out in Appendix 16. Sickness benefits, unemployment benefits and disability pensions were introduced in 1911. Widows' and orphans' pensions were added in 1933. The range of services was further extended with the introduction of contributory old age pensions in 1961, retirement pensions, invalidity pensions and death grants in 1970 and deserted wife's benefit in 1973. Pay-related contributions and benefits were first introduced in 1974 and compulsory insurance was extended to all employees. In 1979, a fully income-related social insurance contribution, up to a ceiling, was introduced in place of the contribution which had been previously levied mainly at a flat-rate.

Social Insurance Contributions

21.5 In Ireland, contributions are levied on both employers and employees in respect of the social insurance services provided by the Department of Social Welfare. Contributions to finance the redundancy payments scheme administered by the Department of Labour are paid only by employers.

21.6 Over 80 per cent of the cost of the social insurance services is financed by social insurance contributions. Redundancy contributions finance payments out of the Redundancy Fund in full. In 1979, these contributions were consolidated in the case of employees, into one contribution which is collected by the Revenue Commissioners, together with a health contribution, through the PAYE system. The standard rate of contribution for 1982/83 is 19.11 per cent, of which 11.61 per cent is paid by the employer and 7.5 per cent is paid by the employee. The redundancy element is 0.5 per cent of income, the health element amounts to 1 per cent of income and 1 per cent is referable to the youth employment levy.

Prospective Developments

21.7 There are a number of prospective developments of the social insurance system which we have taken into account in considering the place of

[2]The main social assistance benefits are: unemployment assistance, non-contributory widow's and orphan's pensions, non-contributory old age pension, deserted wife's and unmarried mother's allowance.

social insurance contributions in the tax system. Proposals for a national income-related pensions scheme are in the course of preparation. The Department of Social Welfare has advised us that

> "Developments in this area will probably intensify the need to use the PAYE tax system for the collection of contributions and of information concerning the earnings of individuals".

21.8 The possibility of extending social insurance to the self-employed is also being examined. In this connection, the Department of Social Welfare stated in its submission that

> "The extension of social insurance to the self-employed would require them to pay contributions to help to meet the cost of social insurance benefits for which they would be eligible. The collection of these contributions if they were on an income-related basis might involve making use of the income tax collection system where appropriate".

Social Insurance Contributions: Tax or Insurance Premiums?

21.9 The first issue to be considered is whether or not social insurance contributions should be regarded as a tax or as an insurance payment solely designed to secure certain benefits. We raised this issue with the Department of Social Welfare who replied as follows:

> "Social insurance contributions are not simply taxation. They enable an insurance record to be built up which gives the employee a title to both short-term benefits and long-term pensions. These benefits and pensions are paid at a higher rate than comparable non-contributory pensions, assistance or allowances and there is no means test. Social insurance contributions are not related to the incidence of unemployment, illness, accident or longevity in various categories because this would be (i) difficult to achieve and (ii) contrary to the principle of risk-spreading which is inherent in any insurance scheme".[3]

21.10 If social insurance contributions were actuarially based, it would be no more appropriate to evaluate them as a tax than, for example, the cost of compulsory third party motor insurance. However, the system is not actuarially based as the following features show:

(i) Pension benefits are financed entirely on a "pay-as-you-go" basis rather than actuarially assessed as with private pension schemes.

(ii) Even on a "pay-as-you-go" basis the system is not entirely self-financed as the Exchequer makes regular subventions to the Social Insurance Fund.

[3]Letter of 12 March, 1981.

(iii) Benefits rise less than proportionately with earnings, although up to £9,500 per annum contributions are strictly proportional. Following the introduction of pay-related contributions the system has been increasingly redistributive.

(iv) Contribution rates in different income classes and employments are not related to a knowledge of the differences in the incidence of unemployment, accidents, sickness or longevity.

(v) Contributions are not refunded in case of permanent emigration.

21.11 The Department of Social Welfare points out that under the existing social insurance system the existence of social insurance contributions enables "an insurance record to be built up which gives the employee a title" to benefits. This was true up until the abolition of the social insurance stamp in 1979, but is no longer the case. Entitlement to benefits (except for pay-related benefits) is now based on the number of weeks of insurable employment paid or credited and not on the amount of income and contributions.[4] It is thus possible for an individual to pay a relatively high amount in contributions and have a lesser entitlement to social insurance benefits than an individual who pays a lower amount in contributions. Information on the number of weeks of employment could be provided by employers through the Revenue Commissioners whether or not there was a separate social insurance contribution.

21.12 The main justification for evaluating social insurance contributions as insurance premiums rather than taxation is the benefit principle. This assumes that workers and employers contribute to a fund to provide income maintenance payments when required. As soon as there ceases to be a close relationship between contribution and benefit, social insurance contributions conform to the two distinguishing characteristics of taxation which we set out in Chapter 1. These are that taxes are compulsory payments to central and local authorities and the benefits do not necessarily accrue to the taxpayers in proportion to their payments.

21.13 We believe that there is no longer a close relationship between the amounts paid in social insurance contributions and the benefits obtained. Contributions are entirely pay-related, but additional contributions do not produce additional benefits except for pay-related benefit which accounts for 7½ per cent of all social insurance benefits. In addition, many of the benefits are differentiated with respect to dependency even though the contributions are not. This redistributive function is an essential and desirable element of the social insurance system. However, it strengthens the case for treating contributions as a form of taxation.

[4]An outline of the contribution conditions to qualify for various benefits is included in paragraphs 17 to 22 of Appendix 16.

21.14 A comparison between social insurance and social assistance payments indicates that as at April 1981, social insurance benefits were between 7 per cent and 27 per cent higher than the corresponding social assistance payments even though the former are payable without a means test. We would expect that in a genuine insurance scheme the insurance benefits should be much higher than the corresponding assistance benefits, given that the insured person makes a contribution towards those benefits.

21.15 We believe that compulsory social insurance contributions are more appropriately regarded as a tax and should be evaluated by the criteria of equity, efficiency and simplicity which we have applied to taxation. Our concern with social insurance contributions is also based on the fact that they are collected through the PAYE system. We have received complaints from employers about the difficulties imposed on them in making returns of tax and information to the Revenue Commissioners.

Incidence of Social Insurance Contributions

21.16 Before arriving at a view on the equity and efficiency effects of social insurance contributions, it is necessary in the first instance to consider their incidence. Social insurance contributions are nominally levied on employers and employees. The formal incidence of these contributions assumes that the employees' element is a tax on the income of the employee and is paid by the employee. It also assumes that the part levied on the employer is a mixture of an employment tax and a payroll tax and is paid by the employer. The effective incidence of these taxes may be elsewhere and may vary, depending on the market structure in which they are imposed.

21.17 The incidence of the part paid by the employee should in theory be the same as that of income tax. We conclude in Chapter 5 that employees may shift at least part of the burden of direct taxation forward to employers. This may be further shifted to consumers or shifted back to employees in the form of higher unemployment, depending on the elasticities of supply and demand both in the labour market and in the individual product markets. For example, given the combination of a strong militant union and a product with a low price elasticity, such as alcohol, it is likely that the employee would be able to shift the burden forward to the employer who, in turn, would be able to shift it forward to the consumer. There is a body of opinion, however, which maintains that while this may be true for income tax, it is not true of the employees' element of the social insurance contribution. It is claimed in the case of the latter that employees, by and large, do not attempt to shift it foward to the employers. On the contrary, it has been represented to us that most employees willingly absorb it on the grounds that they perceive it as a payment, which secures for them a right

to a future stream of social insurance benefits. Although there is no hard evidence to support this view, persons experienced in wage negotiations suggest that this is the case in practice. However, in view of the reactions of employees to increases in social insurance contributions in April, 1982, this view is difficult to support.

21.18 The incidence of the employers' contribution may be analysed as follows. Unless the contribution is shifted in full to employees in the form of lower wages, the effect is to increase the price of labour relative to other factors of production. This gives a boost to the substitution of labour by other factors resulting in lower levels of employment for a given output. This occurs in both the sheltered and unsheltered sectors of the economy.

21.19 In the sheltered sector, the imposition of a payroll tax will be treated like any other cost and will, on the basis of the analysis in Chapter 5, be shifted forward into prices. This conclusion is supported by the fact that the National Prices Commission accepts increases in employers' social insurance contributions as allowable costs in determining price increases. In these circumstances, as far as the domestic consumer is concerned, the incidence of employers' social insurance contribution is likely to be the same as a sales tax.

21.20 In the unsheltered sector, taxation cannot be passed on to consumers in the form of higher prices. Therefore, the burden must be borne by shareholders, suppliers or employees. If borne by employees, this must be in the form of lower wages and salaries or in reduced levels of employment. If borne by shareholders, this may result in lower levels of investment leading to a gradual erosion of competitiveness and a reduction in employment in the longer term. If borne by suppliers, the incidence of the contribution is distributed among their shareholders, employees, customers or suppliers.

21.21 On the basis of this analysis, we conclude that the employees' social insurance contribution in general tends to fall on the labour share of income. The employers' contribution, on the other hand, tends to have a more diffused incidence. It is partly passed on to consumers in higher prices, partly passed on to labour in the form of lower levels of income and employment and partly borne by employers through reduced profits.

Equity

21.22 If the criterion of equity is applied to social insurance contributions they are seen to breach it in the following ways:

(i) Different rates of contributions are levied on persons in different occupations.

(ii) The base on which the contributions are assessed is even more limited than that used for income tax purposes.

(iii) The contributions are regressive due to the application of an income ceiling to social insurance contributors and the fact that no allowance is made for dependency obligations.

Varying Rates of Contributions

21.23 There are, at present, twelve different classes of social insurance contribution. Eleven of these have three variations within the class. Among the classes which pay reduced rates of contribution are permanent and pensionable gardai, army officers, teachers, civil servants and doctors and dentists in the public service. These classes are not entitled to the full range of social insurance benefits. If social insurance contributions are regarded as a form of taxation, the payment of different rates of contribution by different categories is an anomaly.

21.24 The principle of risk-spreading was put forward by the Department of Social Welfare as a fundamental principle to be followed in the levying of social insurance contributions. This seems to us to imply that even if the case for retaining a contribution levied on the benefit principle is accepted, all persons within the social insurance system should be subject to the same rate of contribution regardless of the probability that they will claim benefit. The logical result of the application of this principle is that there should be a uniform rate of social insurance contributions.

Inadequate Base

21.25 The base on which social insurance contributions are levied is narrow when compared to that on which income tax is charged. However, unlike income tax the base is not eroded by a large number of deductions and reliefs. The following types of income at present escape the charge to social insurance contributions:

(i) Income from self-employment;

(ii) Investment income;

(iii) Income received in the form of benefits-in-kind;

(iv) Income realised in the form of capital gains, and

(v) The excess of wage and salary income over £9,500 per annum.

21.26 We argue throughout this report in favour of having a comprehensive income tax base. This is particularly required in order to ensure the achievement of horizontal equity. It is desirable in the case of social insurance contributions that a comprehensive income base be applied,

particularly as almost everyone is entitled to either social insurance or assistance benefits. The fact that these benefits may be either of the insurance or assistance variety is largely immaterial since the relationship between contributions and insurance benefits has been gradually eroded.

Regressivity of Contributions

21.27 One of the main arguments against social insurance contributions is their regressivity. The fact that an individual tax is regressive does not necessarily make it an undesirable form of raising revenue. Regressivity is an essential feature of most indirect taxes. In evaluating a tax system it is the overall progressivity of the tax and public expenditure systems which is important, not the position in relation to individual taxes and benefits. However, we believe that a regressive direct tax which could be made proportional or progressive is unnecessary and undesirable since it requires that element of regressivity to be offset by other taxes in the system.

Efficiency

21.28 Social insurance contributions contribute to inefficiency in the following ways:

(i) By taxing one factor of production — labour as distinct from capital or land or enterprise — they tend to encourage the replacement of labour intensive methods where possible by capital intensive methods of production, particularly in those businesses which cannot shift the taxes fully to employees. This results in higher unemployment.

(ii) They encourage the proliferation of benefits-in-kind which in practice do not carry the burden of social insurance contributions.

(iii) To the extent that they are shifted forward into prices they increase the cost of goods produced in Ireland relative to foreign produced goods thereby having an adverse effect on employment and the balance of payments.

(iv) They tend to discourage the employment of low income earners (largely the young, part-time workers, women and older unskilled workers). Together with other forces, this tends to increase the difficulties which people in these categories have in obtaining employment. The difficulties in this area have been reduced following the introduction of fully pay-related social insurance contributions in 1979.

21.29 It is not sufficient, in our view, to argue that because the level of social insurance contributions in Ireland is relatively low in comparison with major competing countries, the efficiency effects can be ignored.

Whatever other countries may do, if the money raised for social insurance purposes in Ireland were raised in a less wasteful way, the level of employment would be higher and the balance of payments deficit lower.

Simplicity

21.30 The existence of two different direct charges on income under the existing system results in unnecessary complications. It imposes an extra burden on employers (particularly small employers) who are over-burdened by the requirements of complying with fiscal legislation. Social insurance contributions are a separate charge on gross income up to a level of £9,500 per annum. Income tax is levied on all taxable income.

21.31 The existence of these two charges on income also complicates the rate structure. This is clearly shown by an examination of the effective marginal rates (of both income tax and social insurance contributions) which faced a single person in 1981/82 with no allowances other than the personal allowance and Schedule E allowance.

TABLE 27

Combined Marginal Rates of Tax and Social Insurance Contributions for Single Persons at 1981/82 Rates of Tax

Band of Income			Combined Marginal Rate	Range of Total Tax Liability		
£		£	%	£		£
0	—	1,456	3.75	0	—	54.60
1,457	—	2,000	4.75	69.20	—	95.00
2,001	—	2,204	64.75	95.00	—	227.09
2,505	—	2,715	29.75	227.09	—	378.96
2,716	—	7,215	39.75	378.96	—	2,167.71
7,216	—	8,500	49.75	2,167.71	—	2,807.00
8,501	—	9,215	45.00	2,807.00	—	3,128.75
9,216	—	11,215	55.00	3,128.75	—	4,228.75
11,216 and over			60.00	4,228.75 upwards		

Evaluation of Social Insurance Contributions

21.32 We concluded earlier that social insurance contributions should be judged by the criteria applicable to taxation. On doing this we find that they are objectionable in many respects, breaching virtually all the standards normally accepted for taxation. They are regressive relative to income due to the imposition of a ceiling of income above which the same contribution is payable. They fail to take ability to pay into account since the same contribution is payable without regard to marital status. The economic effects of the tax include a higher level of unemployment and a larger balance of payments deficit than if the same amount of revenue was raised by alternative means. The system is more complicated than is necessary.

21.33 We believe that the present system of social insurance contributions is inequitable and complicated and results in the waste of valuable resources. Reform is essential. In the following paragraphs we set out the possibilities in this area.

Options for Reform

21.34 The main options for reform of social insurance contributions are as follows:

(i) Abolish entirely separate social insurance contributions and the Social Insurance Fund and finance social insurance benefits from general taxation.

(ii) Maintain the Social Insurance Fund and finance it by direct payments by the Exchequer out of general taxation.

(iii) Maintain the Social Insurance Fund and finance it with a predetermined share of particular taxes.

(iv) Maintain an employees' contribution and relate the employers' contribution to the employers' income.

(v) Maintain the existing system, but make certain reforms to remove anomalies.

Social Insurance Fund

21.35 A separate Social Insurance Fund was established under the Social Welfare Act, 1952. The fund carries the expenditure only of social insurance schemes. The State is obliged to contribute an amount by which the income of the fund in any financial year is less than its expenditure. The other income of the fund comes from social insurance contributions by employers and employees and from investments.

Earmarked Taxes

21.36 The question arises whether or not a share of specific taxes should be earmarked or assigned for social insurance purposes. We deal with the general question of earmarked taxes and assigned revenues in Chapter 22. As a matter of general principle we are opposed to the concept of earmarked taxes or specific levies. However, we believe than an exception may need to be made for social security purposes. There is an acceptance by the public, arising from historical and psychological factors, of separate levies for social security purposes. For that reason, we do not recommend that social security benefits be financed totally from general taxation at this

stage. This implies the maintenance of a separate Fund along the lines of the present Social Insurance Fund.

A Social Security Tax

21.37 The maintenance of completely separate social insurance contributions which apply to some incomes and not to others is, in our view, inequitable and unnecessary. We recommend that social insurance contributions be replaced by a social security tax charged at a single rate on all income including realised capital gains and taxable gifts and inheritances. This tax should be paid into a separate Fund. Should self-employed persons be brought within the scope of social insurance, their income should not bear a double rate of contribution.

21.38 The social security tax paid in respect of income which arises in the first place to companies should, for the reasons set out in Chapter 27, be fully imputed to shareholders when the profits are distributed as dividends. We do not envisage that this tax would be repaid to exempt funds or foreign residents since these effectively bear some of the burden of the present employers' social insurance contribution which the tax is designed to replace.

Tax Relief for Social Security Tax

21.39 Under the existing system, the amount of the employers' social insurance contribution is given as a deduction in computing the profits of the trade or profession for income tax and corporation tax purposes. Under the arrangements we propose, it would not be appropriate to give relief for social security tax, just as no deduction is allowed for taxes on income such as income tax or corporation tax.

21.40 Employees do not obtain an income tax deduction directly in respect of social insurance contributions payable by them. However, the rate of contribution was adjusted in 1979 to provide some relief. The background to this is dealt with in paragraphs 31 and 33 of Appendix 16. However, the Government has proposed to introduce a special income tax allowance of £312 to be granted in 1982/83 to all employees liable at the standard rate of social insurance contributions. No allowance is being granted to those liable at lower rates.

21.41 We do not accept that the failure to give relief for employees' social insurance contributions, the proceeds of which are used partly to finance

benefits which are taxable, constitutes a special case of double taxation which requires relief. This is because there is no longer a direct and close relationship between benefits receivable and contributions payable. The double taxation argument, if accepted, could equally apply to public service salaries. To allow such a deduction under the existing provisions would transfer some of the burden from the higher-paid to the lower-paid and require higher rates of charge or an increase in general taxation. It would also increase the complexity of the system. On this basis, we do not consider that a deduction for income tax purposes should be allowed to employees in respect of social security tax payable by them.

Basis of Assessment and Collection of Social Security Tax

21.42 The basis of assessment and arrangements for collection of social security tax should be the same as for other direct taxes. This would enable collection of the tax to be integrated fully with the collection of these taxes.

Rate of Tax

21.43 We consider that in present circumstances the rate of social security tax should be about 5 per cent. While this would raise considerably more revenue than the existing employees' contribution if levied at the same rate, the total amount raised would be less than that raised at present from social insurance contributions. Since employers' social insurance contributions are allowed by the National Prices Commission in determining price increases, we would expect that the changes we propose would, in the absence of other tax increases, lead to a reduction in prices. On this basis, we consider that it would be appropriate if the reduction in yield to finance social insurance benefits were paid in the form of an Exchequer contribution to the separate Fund proposed in paragraph 21.37 and raised from indirect taxation.

Conclusion

21.44 The main benefits of the changes we have proposed are a substantial increase in the simplicity of the tax system both for employers and public administrators. The new system would be more equitable and the waste of economic resources associated with the employers' social insurance contribution would be removed. The cost of employing people would fall and an increase in employment should result. In addition, the changes we propose would reduce the price of Irish exports thereby helping to improve com-

petitiveness in export markets. The price of imports would increase relative to home-produced goods leading to an improved market share for Irish made goods in the home market. The proposals would result in a redistribution of the nominal tax burden from employees to the self-employed, from the lower-paid to the higher paid, from workers in the private sector to some workers in the public sector, from employees to unemployed or retired persons and from earned income to unearned income, realised capital gains and taxable gifts and inheritances.

Recommendations

21.45 We make the following recommendations:

1. Social insurance contributions should be replaced by a social security tax levied at a single rate on all income including realised capital gains and taxable gifts and inheritances.
2. The yield from social security tax should be paid into a separate Fund, along the lines of the present Social Insurance Fund.
3. Social security tax should not be allowed as a deduction in computing income or profits for the purposes of income tax or corporation tax.
4. Social security tax paid in respect of income which arises in the first place to companies should be fully imputed to shareholders when dividends are paid out of profits which have borne the tax.
5. Social security tax imputed to exempt funds or non-resident shareholders should not be repaid.
6. The basis of assessment and arrangements for collection of social security tax should be the same as for other direct taxes.
7. In present circumstances, the rate of social security tax should be about 5 per cent. The balance of the Fund proposed in Recommendation No. 2 should be raised from indirect taxation.

Reservation by Mr. Daniel Murphy

1. I am in fundamental disagreement with the view taken by the majority of the Commission that social insurance contributions are a form of taxation. Rather I see them as insurance contributions related to entitlement to benefits. However, I fully support their views regarding health contributions and other assigned revenues. I take the view that an insurance-based scheme is the best way to provide social benefits.

2. All EEC countries except Denmark have social insurance systems with the following features:

(i) Contributions are paid by both employers and employees.

(ii) Employee contributions are related to entitlement to benefits.

(iii) Social insurance benefits are partly financed by the Exchequer from general taxation.

(iv) There is a ceiling on contributions.

3. I consider that the financing of social insurance benefits in Ireland should be based on insurance principles and take the following form:

(i) Employees should pay a contribution on their income from employment at rates related to benefits.

(ii) Employers should pay a matching contribution in respect of their employees but at a higher rate.

(iii) There should be a ceiling on the amount of contributions payable.

(iv) Social insurance benefits should be partly financed from general taxation.

(v) Contributions should not be levied on unearned income, realised capital gains, taxable gifts and inheritances and company profits.

(vi) Should social insurance benefits be extended to self-employed persons, a contribution at the combined employer's and employee's rate should be levied on their earned income from self-employment up to the specified ceiling.

CHAPTER 22

ASSIGNED REVENUES

Introduction

22.1 In this chapter we consider the general question of assigned revenues. These may take the form of earmarked taxes or special levies. In general, we are opposed to the concept of earmarked taxes or special levies and conclude that they should be integrated with general taxation. We pay particular attention to health contributions and the youth employment levy and we recommend that these be abolished as separate charges.

Earmarked Taxes

22.2 It may be argued that the earmarking of particular taxes for specific Government expenditures is desirable, in that it brings home to the public that it is getting value for money paid in taxes in the form of Government services. Proponents of this system contend that this reduces public resistence to taxation. On this basis, separate contributions might be introduced for a wide range of services such as education, public transport, roads and sanitary services.

22.3 The earmarking of particular taxes for services which the public values is a two-edged weapon. It tends to reinforce in the public mind the notion that for the great bulk of taxation no value for money is obtained. This we regard as wholly undesirable.

22.4 We also consider that it is desirable for revenue to be allocated between the competing public expenditure heads on the basis of criteria of need and desirability rather than on the basis of how much revenue is raised under particular tax heads. The latter approach leads to waste.

22.5 However, the main argument against a proliferation of taxes and levies is the additional administrative costs imposed on the public sector and the compliance costs imposed on the private sector. The waste of resources involved is amply illustrated by the experience in the administration of health contributions, which we consider now.

Health Contributions

22.6 Subject to certain specified exemptions the Health Contributions Act, 1979 imposes an obligation on every individual with an income and

who is over 16 years of age to pay health contributions. The rate of contribution is 1 per cent on income from all sources up to £9,500 per annum. It is estimated that receipts from health contributions will amount to £64 million in 1982, which will finance about 6.4 per cent of total estimated current public expenditure on health in 1982.

22.7 Certain individuals are not liable for health contributions, e.g. persons in receipt of widows' pensions under the Social Welfare Acts. Medical card holders are also exempt. If they are employees, the contribution for medical card holders is paid by their employers, unless they are otherwise exempt.

Eligibility for Health Services

22.8 New eligibility arrangements for health services came into operation on 6 April, 1979. One of the major features of the new arrangements is that, at present, hospital services (both maintenance and treatment) in public wards and specialist services in out-patient clinics (with specified exceptions) are available free of direct charge to all persons whose income is less than £9,500 for the year ended 5 April, 1982. Persons whose income exceeds £9,500 are entitled, free of direct charge, to the same range of services except that they are liable for the payment of the hospital consultants' fees. The dependants of those persons who have no independent income, or who are children under 16 years of age, are also covered depending, in the latter instance, on the income level of the parent. Eligibility for health services is not tied to payment of the appropriate health contribution but is a statutory entitlement related to the level of income.

Historical Background

22.9 A Government White Paper[1] of 1966 dealing with proposals for the expansion of health services and the financing of the programme, envisaged that other sources of funding would be sought to supplement the finances to be made available from central taxation. The Government decided at a later stage that a system of health contributions would be introduced payable by persons with limited eligibility for health services, i.e. persons with eligibility for hospital and specialist services, maternity and infant care services and the drugs refund scheme. Persons with full eligibility for services (persons and their dependants covered by medical cards) and certain other specified groups (e.g. female domestics in private employment) were not required to pay health contributions. The Health Contributions Act, 1971 and the regulations made under the Act provided the statutory basis for the health contributions system.

---

[1] *The Health Services and Their Further Development*, White Paper January, 1966 Pr. 8653.

22.10 While the Health Contributions Act, 1971 also contained provision for the subsequent introduction of income-related health contributions, the initial system was based on flat-rate contributions. Employees' contributions were paid on a weekly basis and were paid through the social insurance stamp. The Department of Social Welfare remitted the amounts appropriate to health contributions to the Department of Health. Contributions in respect of the self-employed or persons with incomes not derived from employment were collected separately by the Revenue Commissioners and forwarded to the Department of Health. Health boards were responsible for the assessment of amounts due by farmers and forwarded the proceeds to the Department of Health. The amounts collected from the different sources were appropriated in aid of the Vote for Health.

22.11 In September, 1977, the Government decided, following consideration of a report by an inter-departmental working party on the financing of the social welfare and health services, that a scheme of income-related health contributions should be introduced in lieu of the then existing flat-rate scheme, and that they should be collected with the new pay-related social insurance contribution which was to be introduced at the same time. The new system came into operation on 6 April, 1979. The contribution year coincides with the income tax year.

Collection Arrangements

22.12 For the purpose of collection of health contribution the community is divided into two groups as follows:

(i) Individuals chargeable to tax under PAYE, and

(ii) Other individuals such as farmers, self-employed persons and individuals with mainly investment income.

22.13 In the case of individuals in the first group, the contribution is collected through the PAYE system. The Revenue Commissioners also collect the contribution by direct assessment from Schedule D taxpayers (excluding farmers). The liability of farmers is assessed and collected by the health boards, except in the case of farmers with income from another trade or profession who are dealt with by the Revenue Commissioners.

22.14 The amount of the liability of farmers in respect of income derived from farming is assessed by health boards by reference to the rateable valuation of the farm-land occupied (excluding buildings) and a multiplier which is currently set at 117 per pound of rateable valuation. We have already recommended that existing rateable valuations should not be used to determine tax liability in any way.

22.15 For the self-employed, the Revenue Commissioners have established special collection procedures for health contributions separate from the system used to assess and collect income tax. This machinery operates unsatisfactorily. Demands are issued on the basis of assessments for income tax purposes which in many cases are estimated. There is no enforcement of collection of health contributions, since to attempt to do so would swamp the enforcement agencies to the detriment of the collection of income tax and value-added tax, where much larger amounts are involved. As a result, the collection of health contributions from the self-employed is poor. By January, 1981 payments had been received in only 55.5 per cent of cases for the year ended 5 April, 1980. Despite this the contribution generates a large amount of separate correspondence and special enquiries. In the year ended 30 September, 1980, 38,256 queries about health demands were received by the Collector-General of which about 7 per cent were personal callers. For the year ended 30 September, 1981, the number of enquiries fell to 30,881, but the number of personal callers increased to over 10 per cent of the total.

22.16 We consider that the waste and annoyance caused to the public by this system is intolerable, particularly when it is unnecessary. The compliance costs imposed on taxpayers may be inferred from the nature of their queries. These arise mainly from

(i) claims that the amount charged is excessive. (Most income tax assessments have not been finalised at the time the health contributions charges are made);

(ii) claims relating to PAYE income that

(a) all income is taxed under PAYE.

(b) PAYE income exceeds the maximum chargeable to health contributions.

(c) inadequate or no credit is given for PAYE income;

(iii) farmers billed by both the health board and the Collector-General, and

(iv) non-liable persons.

22.17 Employees who hold medical cards are obliged to produce them to their employers if they wish to be exempt from payment of health contributions. The employer is then liable to pay the contribution. To put an employee in a position in which he must reveal to his employer whether or not he is a medical card holder may be regarded as an unnecessary invasion of privacy. If the employee does not wish to reveal this fact, he must pay the contribution and claim repayment at the end of the year. These procedures are cumbersome.

22.18 The collection of health contributions from farmers by health boards leaves a lot to be desired. Since 1972, the rate of collection of these contributions has been about 82 per cent of assessed liability.

Conclusion

22.19 It is clear that the collection of the revenue from health contributions would be done more efficiently and effectively if health contributions were abolished and the revenue collected from general taxation. Since the payment of the contribution does not confer entitlement to health benefits, it is difficult to see any objections to this course. It would make no difference if the health services were financed entirely out of general taxation.

Youth Employment Levy

22.20 The Youth Employment Agency which was established early in 1982 has two major objectives. These are

(i) to establish, develop, supervise and co-ordinate schemes for the training and employment of young persons, and

(ii) to endeavour to arrange that young persons who are without employment for six months will qualify for participation in a youth employment work experience or training scheme or for assistance in setting up businesses.

22.21 The bulk of the funds for the Agency are being provided through a 1 per cent levy on incomes with effect from 6 April, 1982. There is no ceiling on the amount of the contribution. Holders of medical cards and farmers with a rateable valuation of under £40 are exempt from the levy. Social welfare payments are also exempt. The liability of farmers is collected by health boards. The levy on employees is collected in conjunction with social insurance contributions. The Revenue Commissioners collect the contribution from self-employed persons other than farmers.

22.22 This levy is an additional tax on income. We believe that it would be collected more equitably and efficiently if integrated with general taxation and we recommend that this be done. We see no advantage in maintaining a separate levy.

Recommendations

22.23 We make the following recommendations:

1. Taxes should not be earmarked for specific purposes.
2. The collection of health contributions should be discontinued. The revenue foregone would be more efficiently collected from general taxation.
3. The youth employment levy should be discontinued and the revenue foregone collected from general taxation.

CHAPTER 23

NEGATIVE INCOME TAX

Introduction

23.1 We now consider the case for a negative income tax, which may be taken to cover various forms of schemes for the closer integration of direct taxation and income maintenance schemes. We conclude that in a situation in which resources are scarce, the scope for integration of these schemes is limited.

23.2 We have recommended that certain tax allowances in the system which correspond to social welfare payments should be phased out and increased payments made directly through the social welfare system if this is thought to be necessary or desirable. We also recommended that income tax child allowances be replaced by a child benefit payable directly to the mother. To that extent we have already recommended in favour of rationalisation of the tax and social welfare systems on the lines envisaged in certain negative income tax proposals.

Definition

23.3 Negative income tax is a term rather loosely applied to a number of measures which might be operated through the income tax code and designed to help persons with low incomes. Amongst these measures are

(i) a reverse income tax scheme;

(ii) a refundable tax credit scheme, and

(iii) a social dividend scheme.

23.4 The basic idea of a negative income tax is quite simple. Persons liable for income tax are entitled to income tax allowances in computing their taxable income. The tax saving arising from these allowances depends on the marginal tax rate of the taxpayer. Low income earners who are not liable for income tax receive no benefit from these allowances apart from paying no tax. For example, under the existing code, a married man earning £2,000 per year obtains no benefit from the married persons' allowance. True, he pays no tax, but he would pay no tax at this level of income even

if he were single. On the other hand, the excess of the married allowance over the single allowance in 1982/83 is worth a tax saving of £870 (£1,450 at 60 per cent) to a person liable at the highest rate of tax.

23.5 To counteract this unequal treatment, an income supplement could be paid to those not liable for tax which would be related to the excess of their allowances over the exemption limit. Thus conceived, the income tax system would consist of two parts: those with incomes more than the sum of exemptions plus deductions would pay a positive income tax and those earning less than this or with no income would receive a negative income tax, that is, an income supplement. Using the tax system in this way to supplement the income of those below some tax threshold opens up the possibility of a much more integrated system of personal taxation and welfare schemes. The theoretical attractions of such an integrated scheme such as simplicity, avoidance of high implicit marginal tax rates on income-related social transfers and sharper definition of the scope of welfare schemes can easily be perceived.

Background

23.6 Negative income tax as a concept has its origins in a number of academic papers and policy programmes published in the United States in the 1960's. These were prepared with the aim of alleviating poverty through the income tax code. Each had its own specific objectives and characteristics. Nevertheless, all these plans contain three common features, namely,

(i) a break-even income (i.e. the point where no net tax is paid or net benefit received);

(ii) a guaranteed minimum income for families or individuals with no other income[1], and

(iii) a tax rate on earned income (or a benefit reduction rate).

23.7 These three features or variables are inter-related in such a way that any one of the three is jointly determined by the other two. What is important to note are the conflicting effects of these variables on

(i) the amount of aid given to the poor;

(ii) the budgetary cost of the proposals, and

(iii) work incentives.

23.8 The higher the guaranteed minimum income, the closer the poor are brought to the minimum income standard. To preserve work incentives, the designers of negative income tax plans generally set the tax rate on

[1]This is equal to the break-even income multiplied by the tax rate.

earned income at much less than 100 per cent and often at 50 per cent. But the higher the guaranteed minimum income and the lower the tax rate on income, the higher will be the break-even income and consequently the greater will be the cost of the scheme. The different kinds of negative income tax plans proposed were largely the outcome of these conflicting policy considerations.

23.9 Interest in negative income tax and related concepts was stimulated by the publication in October, 1972 of a Green Paper[2] by the United Kingdom Government outlining proposals for a tax credit system. The Green Paper was adopted as Government policy but following the change of Government in 1974 was only implemented in part. The part implemented was that relating to child benefits which proposed to abolish income tax child allowances over a phased period and replace them with child benefits payable to the mother. This element of the scheme became law with the passing of the Child Benefit Act, 1975.

23.10 A major criticism of the United Kingdom proposals was the relatively small proportion (11.5 per cent) of the total cost of the scheme which would actually go to benefit the most needy.

23.11 Interest in Ireland in negative income tax and related concepts was raised by the publication in 1977 of a report[3] by the National Economic and Social Council. This report outlined three sets of proposals for integrating the income tax and social welfare codes. These were a non-refundable tax credit scheme, a refundable tax credit scheme and an individual grant and tax scheme. Of these only the third, which would involve the payment of a non-taxable social dividend to all persons, could be said to represent a fully integrated approach.

Objectives

23.12 Negative income tax schemes usually have three aims. The first is to achieve administrative savings by simplifying the tax and income maintenance systems. The second objective is to remove "poverty traps" which face taxpayers in certain income ranges and occur when a rise in income is associated with withdrawal of certain benefits and an additional payment of tax. Thirdly, it can be sought to increase the redistribution of income by providing a supplement to the income of the lower-paid. These three objectives are related but distinct and not all negative income tax schemes incorporate all three.

---

[2] *Proposals for a Tax Credit System*. Green Paper, HMSO, Cmnd 5116.
[3] B. Dowling *Integrated Approaches to Personal Income Taxes and Transfers*. NESC Report No. 37.

23.13 We now consider in greater detail the three types of negative income tax noted in paragraph 23.3. Under a reverse income tax, the payment to an individual who is not liable for tax is determined by applying a rate of tax to the difference between the actual income and the exemption limit. For example, if the exemption limit is £50 per week and the rate of negative tax is 50 per cent, an individual earning £20 per week will receive a tax refund of £15 (£50 — £20 = £30 at 50 per cent).

23.14 With refundable tax credit schemes, allowances which were previously given in the form of deductions from income are converted into credits of a fixed amount of tax. Where the credits exceed the amount of tax payable, the difference is refunded to the taxpayer. For example, if the credit for a married couple is £14 per week and the tax payable by the couple is only £10 per week, the excess of £4 is refunded to them.

23.15 The proposal for a social dividend originally put forward by Lady Rhys Williams[1] (and later discussed by both the Meade Commitee[2] and Dowling[3]) is to scrap all existing social security benefits and replace them by a single payment to households, the amount of which would depend on the size and composition of the household. The social dividend would be paid automatically to all households regardless of circumstances, and would be tax-free, thus representing a guaranteed minimum income for each household. All personal tax allowances would disappear and income tax would be imposed on all income other than the social dividend.

Evaluation of Schemes

23.16 Inherent in all negative income tax schemes is the notion of a break-even level of income, that is, the income at which no direct tax is paid and no benefits accrue. If a negative income tax is to deal with the problem of poverty, it is clear that the break-even level of income must be sufficiently high, so that when the negative rate of tax is applied to it the guaranteed minimum income level is at least sufficient for subsistence. This would require the setting of break-even levels of income significantly above the existing level of personal allowances. For example, to provide a guaranteed minimum income equivalent to the old-age non-contributory pension (age under 80) of £34.45 per week[4] for a single person would require a break-even level of income of £5,971 per annum if the rate of negative income tax were 30 per cent. If the rate of negative tax were doubled to 60 per cent the break-even level of income would fall to £2,986 which is still

---

[1] *Something to Look Forward To*, Macdonald, London, 1943.
[2] *The Structure and Reform of Direct Taxation* IFS, 1978, p 277-289.
Integrated approaches to Personal Income Taxes and Transfers, NESC Report No. 37, 1977, pp 76-90, summary opposite page 92.
[4] April, 1982 Rates of Payment.

£936 above the level of personal allowances for a single PAYE taxpayer. To raise personal allowances effectively by this amount would be prohibitively costly. It would also require the imposition of higher marginal rates of tax on taxpayers to try to recoup the benefit of the higher personal allowances.

23.17 For administrative reasons, self-employed persons would have to be excluded from the scope of a negative income tax since it would be impossible to assess their income on a weekly or monthly basis which would be necessary. The fact that about 30 per cent of the population in Ireland is self-employed reduces the attractiveness of negative income tax proposals here.

Conclusion

23.18 Any attempt to solve the problem of poverty with a single comprehensive system of income maintenance which is integrated with the income tax system would be very costly. The problem with negative income tax schemes is that the level of personal allowances or credits must be fixed at a high enough level to provide at least a subsistence level of income and these must be extended to everybody. This would imply a higher single rate of tax beyond the income maintenance level than we generally have in mind. Hence, the benefits of a neater, more rational tax benefit system at the lower end of the income scale would still be offset by implicit disincentives and steeper progressivity at most income levels. A negative income tax would reduce the flexibility of the tax system we propose. A combination of selective payments and credits would allow a more effective approach. Good design could lessen the poverty trap problem at lower income levels (something which will be aided by our other recommendations). When resources are scarce the only method of granting an acceptable level of income to the poor is to make selective payments to them and not to give universal payments to everyone regardless of income.

23.19 In Chapter 16 we considered and rejected the notion that personal allowances or credits should be fixed at a level equal to minimum subsistence. In our view, their sole purpose is to ensure that there is a sufficient difference in the relative amounts of tax payable by persons with the same income but different dependency and other obligations. We also concluded that the most effective and efficient way of helping the poor is not to exempt them from taxation, but to ensure by means of direct payments that they have an adequate income. By divorcing personal allowances from the issue of subsistence, the single personal allowance (or credit) can be set at any level and the married personal allowance (or credit) fixed to ensure a satisfactory relative difference in tax liability. This could enable a substantial reduction to be made in marginal rates of tax thereby bringing

marginal and average rates closer into line, if allowances or credits were reduced.

23.20 We believe that our approach, which involves the continued separation of direct tax and income maintenance schemes, meets the objectives set for negative income tax schemes noted in paragraph 23.12 better than these other schemes. Firstly, and most importantly, it is the only method of providing an acceptable level of income maintenance. Secondly, it enables substantial simplifications to be made to the income tax code without causing further complications to income maintenance schemes. Thirdly, by lowering marginal rates of income tax across the board, poverty traps may be reduced. Finally, our approach has a beneficial effect on work incentives by enabling lower marginal rates of tax to be charged on most taxpayers at work than would be the case if negative income taxation were introduced.

Recommendation

23.21 We make the following recommendation:

1. The direct tax and income maintenance systems should continue to be separate.

Part IIB

The Taxation of Business, Corporate and Investment Income

CHAPTER 24

THE JUSTIFICATION FOR COMPANY TAXATION

Introduction

24.1 In this chapter we examine the case for a separate tax on company profits. We conclude that, in principle, there is no case for such a tax but that tax should continue to be collected at the company level as a prepayment of shareholders' liability in order to avoid companies being used as a means of delaying tax due by shareholders.

Relationship between Company and Shareholders

24.2 Before determining the appropriate taxation arrangements for income which accrues in the first place to companies, it is essential to come to a view on the relationship between a company and its shareholders for tax purposes. There are two views on the subject: the first is that the company is a separate taxable entity in its own right and the second is that the company is a vehicle through which the shareholders decide to conduct their business.

24.3 Those who maintain that a company and its shareholders are entirely separate entities believe that a company has a separate taxable capacity and should be subject to a separate and distinct tax. This view leads inevitably to the conclusion that the taxation of company profits should be completely separate from the taxation of personal income and that no account need be taken of the amount paid at the company level in determining the income tax payable by shareholders on distributed profits.

24.4 The separate entity view is based on the fact that companies, especially large public companies with wide share ownership, have direct command over economic resources to which the shareholders have no direct access and make important economic decisions over which the shareholders have no control. Accordingly, companies are considered to be taxable entities in their own right. We do not accept this view. While companies are legal entities that transmit money to the Exchequer, they

cannot bear the burden of taxes. What they do is collect money from individuals — their customers, their suppliers, their employees, or their shareholders — and transfer it to the State.

24.5 It is not possible to tax corporations and leave people untouched. The incidence of corporation tax is an area of economics with a large literature and little or no agreement. Depending upon the exact assumptions used and the time periods under consideration, it could be a tax on shareholders, a sales tax on customers or a tax on employees. It may also be shifted to suppliers. However, one thing is certain, the tax is borne by individuals and not by institutions.

24.6 The alternative view is that the identity of a company and its shareholders are inseparable. The company is regarded as no more than a group of shareholders who have come together to earn income through the medium of a particular legal entity, i.e. the company. The company is regarded as a mere conduit for transmitting the earnings of the company into the hands of its shareholders. As a result, the company does not have a separate taxable capacity.

24.7 The argument upon which the one entity view is based is that while income from economic activity accrues initially to various types of legal entity, such as individuals, partnerships, trusts and companies, all income ultimately accrues to individuals. Thus, the current income of a company may be distributed to shareholders in the form of dividends. If it is not distributed, it will be retained by the company with a view to earning future income for the shareholders. The retained profits may be distributed in later years but, even if they are not, the shareholders will benefit from the increased capital value of their shares as a result of the addition to reserves.

24.8 The broad concept of income, which we have adopted, recognises income as being attributable to individuals only and not to organisations. In theory, the annual income that an individual derives from ownership of an interest in a company should be measured as the sum of

(i) the dividends and other distributions received during the year, and

(ii) the annual change (in real terms) in the market value of his shares in the company.

The individual's total income over time would be the sum of dividends received throughout the period of ownership of the shares and the difference (in real terms) between the original cost and the amount ultimately realised on the sale of the shares. If the annual income of shareholders could be measured and charged to personal income tax on this basis and if all

shareholders were resident in Ireland, there would be no need to levy any tax at the corporate level.

24.9 To apply this concept of taxing income from companies would require an annual valuation of all shares. The difficulties of doing this are discussed at length in paragraphs 13.18 to 13.25. In the case of publicly-quoted shares this would be relatively easy, but for closely-held family companies valuation would be so contentious, costly and time-consuming as to be impracticable. It would also give rise to cash flow difficulties for shareholders. Once it is conceded that income from company shares cannot be taxed on an annual accrual basis it becomes necessary to prevent the undue postponement of tax liability which would result if individuals were taxed only on dividends received and income was accumulated in companies. If there were no tax on the retained profits of companies, individuals who could arrange to receive their income through companies could retain their savings, free of tax, in the company. The result would be to give a tax advantage which could not be justified to company shareholders *vis-à-vis* other taxpayers.

Limited Liability

24.10 The only argument for imposing a separate charge on companies, over and above that levied on unincorporated entities, is that companies enjoy the privilege of limited liability. However, the probability of utilising this privilege is related inversely to the level of profits earned. For this reason, we do not consider that a higher rate of tax on company profits may be justified on these grounds.

Retained Profits

24.11 We have argued that to charge distributed profits to personal income tax while leaving undistributed profits free of tax would be inequitable and would favour shareholders relative to other taxpayers. From this we have concluded that a tax on undistributed profits is needed in addition to a tax on personal income. However, to the extent that company tax is passed on, it may be argued that it does not provide the required degree of equity. We do not accept this. The suggestion that there should be no tax on undistributed profits could be supported only if it could be clearly shown that this tax was always passed on in full by companies and was not shifted by unincorporated businesses. There is no firm evidence that this is so.

Conclusion

24.12 Under a system which taxes income on a comprehensive basis the correct treatment, in principle, of income arising to companies would be to allocate to each shareholder his share of the earnings of the company

which had not been paid out in dividends. The basic idea would be to tax the company as if the shareholders formed a partnership. This is not possible in practice, particularly in the case of companies with wide share ownership. We consider later whether the partnership method should be applied to close companies. If there were no tax on retained earnings of companies, shareholders would be given an unjustifiable advantage over other taxpayers. For these reasons, we conclude that, while, in principle, there is no case for a separate tax on company profits, such a tax should continue to be collected at the company level as a prepayment of shareholders' liability.

CHAPTER 25

PRESENT SYSTEM OF COMPANY TAXATION IN IRELAND

Introduction

25.1 In this chapter we describe the general system of corporation tax as it applies in Ireland at present. The historical development of this system and the main incentive reliefs which now exist are set out in Appendix 17.

General Basis of the Tax Charge

25.2 Subject to certain exemptions, a company which is resident in Ireland (that is, one whose business is managed and controlled here) is chargeable to corporation tax on all its profits and income wherever arising. A company which is not so resident is chargeable to corporation tax on the trading income of its Irish branch and on any other income or chargeable gains attributable to the branch. All non-resident corporations are chargeable to income tax (at the standard rate) and to capital gains tax on any income and chargeable gains arising in Ireland which are not attributable to a branch or agency operating here. A company is defined as any body corporate but does not include a health board, a vocational education committee, a committee of agriculture or a local authority. In the remaining sections of this chapter we deal only with the charge to corporation tax.

Computation of Profits

25.3 The basic rule for the computation of income for corporation tax purposes is that, in general, it is to be computed in accordance with income tax principles. The basic rule for the computation of chargeable capital gains is that they are to be computed in accordance with the principles applying for capital gains tax. The amount of capital gains to be charged to corporation tax in the profits of a company for an accounting period is the net amount of the chargeable capital gains accruing in the accounting period after deducting the allowable losses of that and earlier periods. The amount which is charged at the normal corporation tax rate is fixed so that the tax due is equivalent to a charge at the normal capital gains tax rate on the total amount of gains.

25.4 Companies subject to corporation tax are entitled to certain reliefs for losses, for capital expenditure on certain buildings, machinery and plant and for appreciation in the value of trading stock. Full relief from corporation tax is granted in respect of profits from certain export sales of manufactured goods and profits from exempted trading operations within Shannon Airport. Alternatively, since 1981, relief may be claimed in respect of profits from sales, whether export or domestic, of goods manufactured in the State, so that the effective rate of corporation tax is reduced to 10 per cent (see Appendix 17).

Basis of Assessment

25.5 Corporation tax is assessed on the profits arising in the company's accounting period. An accounting period is a period of not more than twelve months and is normally the period for which a company makes up its accounts. The rate of tax is fixed for a financial year (the calendar year). Where a company's accounting period does not coincide with a financial year and there is a change in the rates of tax, the profits of the accounting period are apportioned on a time basis between the two financial years concerned.

Rates of Tax

25.6 As from 1 January, 1982 the standard rate of corporation tax is 50 per cent on the income of a company whose profits exceed £35,000. Where the profits do not exceed £25,000[1], the company's income is taxed at 40 per cent. Marginal relief is given in taxing the income of companies with profits between £25,000 and £35,000. The net effect of these provisions is that the rate structure of corporation tax is as follows:

Band of profits	Rate of charge
	%
The first £25,000	40
The next £10,000	75
The balance	50

25.7 Building societies, the Agricultural Credit Corporation Ltd., certain public utility companies and companies which are precluded from distributing their profits are charged to tax on their income at a special rate of 35 per cent.

[1] For the purpose of these limits of £25,000 and £35,000, profits are deemed to include any distributions, plus their tax credits, received from Irish resident companies and, if a company has one or more associated companies, the limits are reduced for that company by dividing them by one plus the number of associated companies.

Distributions

25.8 Where a distribution (usually a dividend) is made by a resident company, part of the corporation tax on the income underlying the distribution is imputed to the recipient by way of a tax credit. The tax credit normally amounts to three-sevenths of the net distribution. Special arrangements relate to companies liable to tax at the rate of 10 per cent applicable to manufacturing companies.

25.9 An individual resident in Ireland is liable to income tax (under Schedule F) on any distributions received from a resident company. This liability is on the aggregate of the distribution and the tax credit, but the tax credit is set against the income tax due. Where the shareholder is liable to income tax at a higher rate than the amount of the credit, the tax credit is deducted from the tax payable. A shareholder, who is not liable to tax or is liable at a rate less than the amount of the credit, may claim payment of all or part of the tax credit as appropriate.

25.10 A company may receive dividends or other distributions from other companies. Where the paying company is resident in Ireland, such distributions are not chargeable to tax in the hands of the recipient company. The recipient company may claim payment of the tax credit in respect of such distributions, if it has losses which can be set against them.

25.11 A person (company or individual) who is not resident in Ireland is not entitled to a tax credit in respect of dividends unless this is provided for in a double taxation agreement or unless the recipient, being a non-resident individual, is entitled to the proportion of his personal allowances that his Irish income bears to his world income.

Payment of Corporation Tax

25.12 Companies are required to pay corporation tax in two instalments. Under proposals in the Finance Bill, 1982, the first payment is due six months after the end of their accounting period. The date of payment for the second instalment can vary as between companies from six to fifteen months after the end of the accounting period.

Groups and Consortia

25.13 Group relief is provided for resident companies which have a 75 per cent relationship. This entitles one member of a group of companies to surrender its trading loss to another member of the same group. Group relief is also available to members of a consortium where the loss-making company is owned by a consortium. A consortium exists where five or fewer companies own between them all the ordinary share capital of a

trading company or of a holding company whose business consists, wholly or mainly, in the holding of shares in trading companies which are its 90 per cent subsidiaries. The loss-making company cannot be more than a 75 per cent subsidiary of any member of the consortium.

25.14 Shares held by a company for the purposes of a business of dealing in investments cannot be the basis of a claim to group relief. Profits or losses on disposals of such shares are treated as receipts or expenses of the business of dealing in investments. There would be the possibility of a double allowance if group relief were available in respect of a part of the trading losses of the company in which such shares are held, while a loss on disposal of such shares fell to be treated as a trading expense. Thus, a bank would not be entitled to group relief in respect of losses of companies whose shares form part of the bank's dealing portfolio but it would be so entitled in respect of losses of its subsidiaries which are part of a structure through which its business is carried on.

Close Companies

25.15 There are special provisions in relation to close companies which are, broadly, companies under the control of five or fewer participators or of its participators who are directors. Where the aggregate of the investment and rental income available for distribution for an accounting period by a close company exceeds the amount actually distributed within eighteen months after the end of the accounting period, a surcharge of 20 per cent of the excess is levied. Where the undistributed income is £500 or less, the surcharge is not applied and for amounts slightly over £500 there is marginal relief.

25.16 A surcharge is also imposed in the case of a close company, the principal part of whose income is derived from a profession, the provision of professional services or the exercise of an office or employment. The surcharge for an accounting period in such a case is on the excess of the aggregate of 80 per cent of the professional income available for distribution and the whole of the investment or rental income over the distributions for the accounting period.

Participators and Associates of Close Companies

25.17 There are a number of special rules relating to transactions between close companies and their participators and associates. The general definition of a participator in a company is a person who has a share or interest in the company's capital or income. An individual's associates include a spouse, a partner or direct relatives. Where a close company provides benefits of any kind for an associate or a participator of the company who is not a director or employee of the company, then the company is deemed

to have made a distribution equal to the amount of that expense. This means that the expense is not allowed in computing the company's profits for tax purposes. The recipient of the benefit is deemed to have received a distribution plus the associated tax credit and is chargeable to tax on the gross amount. Benefits-in-kind received by directors or employees of close companies are charged in their hands under the general benefit-in-kind provisions.

25.18 In certain circumstances, interest paid by close companies to directors and their associates, in so far as it exceeds a reasonable limit, is also treated as a distribution.

25.19 If a close company (whose business does not include the making of loans) makes a loan to a participator or associate, the company is obliged to pay to the Revenue Commissioners income tax at a rate of 35/65 ths of the amount of the loan. To the extent that the loan is repaid, the company may reclaim the tax. If the loan is released or written off, the loan plus the associated tax deducted, is treated as income of the borrower in the year in which the loan is written off and the tax paid over is allowed as a credit to the borrower and ceases to be recoverable by the company.

25.20 There is an exception to these provisions where a loan of not more than £15,000 is made to a participator or an associate who is a director or employee of the close company or of an associated company. The loan must satisfy three conditions. Firstly, the aggregate of the loans made to the borrower or the spouse by the close company or its associated companies must not exceed £15,000. Secondly, the borrower must work full-time in the close company or in an associated company. Thirdly, the borrower together with his associates must not directly or indirectly control more than 5 per cent of the ordinary share capital of the company.

CHAPTER 26

THE DETERMINATION OF BUSINESS INCOME

Introduction

26.1 In this chapter we consider how our concept of income should be applied in order to determine business income for tax purposes. We are not concerned here with any reliefs which may be thought desirable as incentives for particular activities. In this chapter we merely set out the basic system which should be applied. This provides a benchmark against which incentives may be measured. Profits earned by the entity, having maintained intact its capacity to continue as a going concern, should in principle be the basis of taxation. Accountancy is in a process of evolution and development because of perceived inadequacies in the traditional historical cost convention. This process is as yet incomplete. We consider that the tax system should facilitate, rather than inhibit the evolution of an improved method of accounting. Our recommendations are set against this general background.

26.2 In the absence of any statutory definition of income, it is an established principle, endorsed by the Courts, that profits for tax purposes are to be computed in accordance with the ordinary rules of commercial accounting, except where the Taxes Acts decree otherwise. Even if income were to be defined for tax purposes, it would be necessary to start with accounts prepared for normal commercial purposes. Under existing practice, it would follow that if current cost accounting principles satisfied the ordinary rules of commercial accounts, tax liability would be based on current cost profit rather than historical cost profit.

The Going Concern

26.3 Special problems arise in determining business income in periods of inflation. We believe that, in computing the income arising from a business, account must be taken of the fact that the business is a going concern and will continue in operation for the foreseeable future. This implies that the profit of the business entity is the amount which remains after having maintained intact the operational capacity of the enterprise and before

remunerating the providers of equity and debt capital. Where the business is not a going concern, different accounting treatment arises and the assets are valued by reference to their alternative use.

Accounting Objectives

26.4 The objective of accounting is to provide true and relevant information to the users of financial statements. To do so, the accounts should provide a measure of the financial position of the enterprise, of its owners' equity at a particular date, of the enterprise's performance and of the income which its owners derive from their investment over a particular period. The term enterprise is used here to refer to all businesses and other income earning entities which require the preparation of financial statements, ranging in size from the small retail operation or farm to the largest manufacturing, financial and trading concerns.

26.5 There are two main accounting conventions now in general use in Ireland and the United Kingdom, each based on a particular concept of capital and of costs. Current cost accounting has been prescribed for larger companies which must also provide certain historical cost information, or which may publish historical cost accounts complemented by current cost information, if they so wish. At present, historical cost accounting is used by a majority of smaller entities. Current purchasing power accounting has not been prescribed but it is another approach which attracted our attention because it is consistent with our definition of income. We describe these three conventions in the following paragraphs.

Historical Cost Accounting

26.6 The chief distinguishing characteristic of historical cost accounting is that, as far as possible, profit is measured by reference to the difference between the amount for which goods are sold and the actual purchase price or production cost of the goods. That convention has, however, been subject to modification, particularly within the last twenty-five years, in that periodic or regular revaluations of fixed assets have been incorporated into financial statements in Ireland and the United Kingdom (although it should be noted that in the United States of America this modification is regarded as unacceptable and contrary to the principle underlying the historical cost convention).

26.7 In comparing an enterprise's revenues and expenses for the purpose of establishing its profit in a period of inflation, some items of revenue and expense may be expressed in different prices from those used to measure other items, depending on the timing of the different transactions. In a particular accounting period, most items of revenue and some expenses (e.g. wages and salaries) are stated in terms of the prices of the period

because the transactions take place in the period. But other items of expense, in particular those associated with using stocks or fixed assets in the process of generating revenue, may be expressed in terms of the prices of a past period.

26.8 The historical cost method purports to measure profit by a process of matching costs against revenue, taking costs on a historical basis. Various methods have been developed for allocating costs against revenue as and when assets are used up in the revenue-producing process. Until realisation, non-monetary items are usually measured by reference to their historical cost (with allowance for depreciation in the case of fixed assets other than land). However, as noted earlier, fixed assets may be shown at a current valuation. Monetary items are recorded in the balance sheet at historical values. No attempt is made to record gains or losses from holding monetary assets or liabilities during periods in which changes occur in price levels.

26.9 Under historical cost accounting, the cost of purchasing fixed assets which are expected to have a useful life of more than one year is not charged in full to the profit and loss account for the year in which they are purchased. For each year of the estimated useful life of the asset, an appropriate proportion of the total depreciation relating to the fixed asset is charged against the profit and loss account in order to match revenue earned in a particular year against that part of the cost or in some cases the value of the fixed asset assumed to be consumed in the generation of the revenue.

26.10 When the prices of assets held by an enterprise are stable, historical cost profit will be equal to profit after providing for the replacement of assets consumed. In such circumstances, if we ignore technological change, the depreciation provided under historical cost accounts will allow for the replacement of the existing assets when their useful life is over. However, when the price of a fixed asset possessed by an enterprise increases during its working life, a depreciation provision calculated on the basis of the historical cost of the asset will still spread the acquisition cost incurred by the enterprise in purchasing the asset over its estimated useful life but *will not lead* to an accumulated depreciation provision equal to the cost of replacing the asset at the end of its useful life. For the enterprise to maintain its existing capacity in these circumstances, it will have to acquire additional funds in the form of higher borrowings or increased equity from shareholders.

26.11 There are major defects in historical cost accounting in the way in which it accounts for both fixed and circulating assets which become manifest in times of changing price levels. The concept of profit in historical cost accounting does not recognise any change in the general purchasing power of money or any change in the specific costs of individual assets between acquisition and replacement. When prices are rising, the historical

cost method fails to make an adequate charge against revenue for the current cost of resources consumed during the period. Moreover, it fails to identify separately operating profit of the enterprise and gains made from holding assets in times of rising prices.

26.12 Any resulting overstatement of operating profit of the enterprise and understatement of assets employed may have several important consequences for enterprises. The first is that it may so mislead the management of an enterprise as to its real position that they distribute to owners what are thought to be profits to an extent that is inconsistent with the ability of the enterprise to maintain its productive capacity. Secondly, failure to recognise in the accounts the effects of price level changes can lead management to adopt unrealistic pricing policies as a result of incorrect costing information and can also result in faulty investment decisions. The third consequence flows from the fact that Government, in making economic policy decisions in relation to taxation and resource allocation, looks naturally at profitability as measured for accounting purposes. The Irish tax system, broadly, takes the accounting profit on the historical cost basis for computing tax liability. This tends to absorb in taxes funds which are needed to maintain the operating capacity of the enterprise. This tendency has been mitigated in the case of manufacturing industry, and latterly in the case of certain service industries, by the introduction of incentive reliefs such as stock relief and accelerated capital allowances. Whether by way of grants, reliefs or unemployment payments to those affected by the original misjudgements, the State is left with a substantial liability.

26.13 Two major advantages are claimed for historical cost accounting. Firstly, data as to historical cost can, for the most part, be readily verified by reference to accounting records and source documents. Secondly, it has in the past been generally accepted by most professional accounting bodies, Governments and users of financial statement, and its principles and practical application are well understood. The degree of objectivity inherent in historical cost accounting makes it administratively suitable for taxation because there is less scope for manipulation than with more subjective methods.

26.14 While recognising these advantages and acknowledging that, in times of stable prices, historical cost accounting substantially meets the needs of users of financial statements, we believe that some of its advantages can be and are overstated. In particular, the historical cost system has already departed substantially from the objectivity criterion. This departure has taxation implications. Firstly, accounting conventions allow the use of valuations involving the making of judgements. These conventions affect both current and fixed assets and may have a substantial impact on profit and net asset figures. Secondly, judgement is required in determining such matters as

(i) whether a debt is irrecoverable and should be written off;

(ii) whether a sum received has been earned;

(iii) what provisions should be made, and

(iv) what is the valuation of items such as goodwill and other intangibles.

Thirdly, depreciation involves making judgements as to the residual value, the economic life and the appropriate method and rate of depreciation for for the item concerned. This also involves a departure from objectivity but, since the tax allowances for depreciation are set down in legislation, any element of judgement on these items does not change liability for tax. It may be said also — and this applies irrespective of which particular accounting convention is adopted — that the ascertainment of profit or loss in a business enterprise of any size is not simply a mathematical exercise. Rather, it is typically an amalgam of arithmetic, estimation, judgement, compliance with company and other law and the application of accounting principles and conventions.

Current Cost Accounting

26.15 To cope with the problems of accounting in times of changing prices a Statement of Standard Accounting Practice (SSAP16), known as the Current Cost Accounting Standard, was issued on 31 March, 1980, by the Accounting Standards Committee which is representative of the major accounting bodies in Ireland and the United Kingdom. The standard applies to all annual financial statements intended to give a true and fair view of the financial position and profit or loss of entities. Certain exemptions are provided in SSAP16 (Appendix 18) to facilitate the implementation of current cost accounting. These exemptions are based mainly on size and business-type criteria.

26.16 The standard requires that, in respect of accounting periods commencing on or after 1 January, 1980, annual financial statements include, in addition to historical cost information, current cost accounts comprising a profit and loss account, balance sheet and explanatory notes. It offers three choices, any of which will comply with the standard:

(i) Historical cost accounts with supplementary current cost accounts;

(ii) Current cost accounts as the main accounts with supplementary historical cost accounts, and

(iii) Current cost accounts as the only accounts with historical cost information disclosed in accompanying notes.

26.17 Current cost profit and loss accounts start with the profit before

interest and taxation, as shown in the historical cost accounts. Three adjustments are then made to the historical cost trading profit to arrive at the current cost operating profit. These are the depreciation, cost of sales and monetary working capital adjustments. The depreciation and cost of sales adjustments take into account the current value (rather than historical cost) of the stocks and assets consumed in the business during the year. The monetary working capital adjustment reflects the amount of additional or reduced monetary working capital for the period as a result of changes in prices. The current cost operating profit arrived at after these adjustments is the surplus after allowing for the impact of price changes on the funds needed to continue the existing business and maintain its operating capability, but without taking into account the way in which it is financed.

26.18 A fourth adjustment is made in the current cost accounts to recognise the effects of gearing in the business. The principle here is that, where the fixed assets and net working capital of the business are provided through a combination of equity and borrowings, an adjustment should be made to take into account the benefit to shareholders of borrowing in fixed money terms against assets which are increasing in value during a period of rising prices. The combined effect of the gearing adjustment and the interest cost gives the net realised benefit to the shareholders from borrowings. The gearing adjustment represents that proportion of the depreciation, monetary working capital and cost of sales adjustments which is attributable to finance provided by net monetary liabilities exclusive of amounts, if any, already included in the monetary working capital adjustment. It has the effect of reducing the current cost accounting adjustments to the amounts that have to be financed from ordinary shareholders' capital.

26.19 In the current cost balance sheet, fixed assets and stock are shown at the current value to the business (normally net current replacement cost). The balance sheet also includes a current cost reserve which reflects the current cost adjustments.

Current Purchasing Power Accounting

26.20 The profit of an enterprise in terms of current purchasing power is the same as under the historical cost method, except that the following adjustments are made in inflationary conditions:

(i) *Stock:* An additional charge is made based on restating the opening stock of current purchasing power as at the end of the financial year.

(ii) *Depreciation:* Additional depreciation is deducted based on the cost of the fixed assets measured in terms of pounds of current purchasing power.

(iii) *Sales, purchases and other costs:* These are increased by the change in the index between the average date on which they occurred and the end of the year.

(iv) *Gain/loss on holding net monetary liabilities/assets:* Gains or losses in purchasing power on the holding of net monetary liabilities or assets are taken into account.

26.21 When prices are rising, the effect of the adjustments in respect of stock and depreciation is to reduce profit below that shown in historical cost accounts. The effect of the adjustment in respect of sales and other costs is to increase the profit where increases in sales exceed the increases in costs included in this heading. Holding gains and losses in respect of monetary items are shown separately. Holders of net monetary assets lose general purchasing power during inflation. Conversely, holders of net monetary liabilities gain. A more detailed description of current purchasing power accounting is set out in Appendix 19.

Essential Features of Accounting System Used for Tax Purposes

26.22 We believe that the essential features of any accounting method to be used as a basis for computing profits for tax purposes are as follows:

(i) *There should be consistency between taxpayers:* The accounting system should produce consistent results within itself so that those in similar circumstances (as measured by the same accounting system) are treated in the same way.

(ii) *It must be capable of implementation by all taxpayers:* An accounting system should not be such that it can be used only by businesses which have sophisticated accounting facilities. It must be capable of being applied to small business.

(iii) *Standards must be clearly established and uniformly applied:* No system of accounting will ever be completely consistent in practice. To determine what is or is not acceptable, the Revenue Commissioners would need to have a clear code of practice against which departures can be assessed. We consider that the Statements of Standard Accounting Practice prepared by the Accounting Standards Committee and promulgated by the constituent bodies of the Consultative Committee of Accountancy Bodies (CCAB) meet this requirement.

(iv) *It must be capable of verification:* As all original records represent historical cost, nothing should inhibit verification of the final accounts working from that source material. We consider that audited accounts, in respect of which an unqualified audit opinion has been given are presumptive evidence of acceptability.

Conclusion

26.23 The experience of inflationary conditions in recent years has highlighted the deficiencies of historical cost accounting. Conventional financial statements have lost much of their significance and have, in many cases, seriously distorted the perceived financial position of enterprises. By largely ignoring price changes of non-monetary items and entirely ignoring the impact of inflation on monetary assets and liabilities, historical cost accounts fail to provide an up-to-date measure of the resources and operating profit of the entity. This omission often leads to an incorrect assessment of past and current performance, present position and future prospects of the enterprise. Historical cost accounts fail to match current revenues against current costs, which leads to a mis-statement of profits. As a result, we consider that historical cost profit is inappropriate for tax purposes.

26.24 There is a growing acceptance within the accountancy profession of the value of current cost accounting and its superiority over historical cost accounting in measuring the performance of business. However, the new accounting standard, while established for larger businesses, is not yet in widespread use. We consider that the acceptance and general use of improved accounting methods for business purposes would significantly icantly improve business decisions and lead to a better allocation of resources and higher economic growth. For this reason, we believe that any recommendations which we make should promote, rather than hinder, the application of improved accounting principles.

CCA Versus CCP

26.25 We now consider the relative merits of current cost accounts and current purchasing power accounts as a basis for taxation by reference to our criteria of equity, efficiency and simplicity.

26.26 We have defined income as the amount which an individual may consume in a period while maintaining the real value of his capital intact. Because all taxation is ultimately borne by individuals, we have adopted the concept of individual command over economic resources as our measure of equity or ability to pay. To identify volume changes in the command over economic resources, a general price index (which reflects changes in the price of personal consumption) is required. When the price of an asset increases faster than this general index, we include the extra increase in our concept of income because it represents a potential increase in the volume of personal consumption for the asset-holder, whether he chooses to exercise it or not.

26.27 Our definition of income could be applied to business entities by estimating the maximum amount they could distribute to their shareholders and maintain their capital intact in real terms. In order to achieve equity

between taxpayers, the capital required to be maintained for these purposes could be regarded as the purchasing power of the shareholders' or proprietors' interest in the enterprise at the beginning of the year. This would be measured by changes in an index of general purchasing power of personal consumption. This is the approach adopted by current purchasing power accounts.

26.28 While this concept of capital maintenance is consistent with our definition of income, it has little relevance to the maintenance of the business entity as a going concern, which is the issue of primary importance to its owners, managers and employees.

26.29 We believe that if it were generally adopted by business current cost accounting would result in greater efficiency. In charging revenue with the current cost of earning that revenue and in showing assets at their current valuation, current cost accounting provides information needed to measure the performance of an enterprise and to assess its future prospects. The current cost profit, that is, the gain arising during a period after charging that part of the value of the assets consumed in the period, provides a basis for rational policies on pricing and earnings retention. It recognises the going concern concept of a business and enables the enterprise to maintain its operating capacity. This is due to the emphasis it places on ensuring that charges to revenue for assets consumed in generating that revenue are based upon current prices specific to the business. Current purchasing power accounts on the other hand use general prices which may not coincide with the specific price changes faced by an individual business.

26.30 We believe that the adoption for tax purposes of accounting based on current cost principles would accelerate the completion of the process of replacing historical cost accounting. This would result in significant efficiency gains. However, the tax system cannot lead the way in this area but must follow generally accepted accountancy practice.

26.31 Current cost accounting is now confined to a small number of relatively large enterprises. For many of the smaller concerns, recording and accounting are very much secondary to the running of the business, with much of the work done by the owners after normal business hours. The adoption of current cost accounting would impose an additional burden on such individuals.

26.32 During the course of our review we had discussions with Mr. Kenneth Sharp who was Chairman of a Working Party set up by the Accounting Standards Committee to give guidance on the easiest way in which the family business can adopt the Standard on Current Cost Accounting. The Working Party produced a manual[1] to show how SSAP16 can be applied in a simple manner by businesses with relatively straightforward operations and unsophisticated accounting systems.

[1] *CCA The Easy Way*, Accounting Standards Committee, 1980.

26.33 In a memorandum to us the Department of Finance and the Revenue Commissioners opposed the adoption of current cost accounts as a basis for taxation because

> "the current cost accounting system affords a much greater scope for subjective judgements which are not capable of being audited".

26.34 We consider that while current cost accounting involves a higher degree of subjectivity than historical cost accounting this is confined mainly to estimating the value to the business of assets and relates mostly to the depreciation adjustment. Since depreciation, as included in financial statements, is not an allowable deduction for tax purposes, this does not arise as an argument against the use of current cost accounts as a basis for taxation. All the other current cost adjustments are capable of independent verification.

26.35 The adoption of current purchasing power accounts for tax purposes would be relatively simple and inexpensive since all that is involved is a standard adjustment to historical data. This system has the advantage of being objective, easy to verify and, since the method is basically supplementary to the historical cost accounting method, it would lend itself to relatively smooth transitional arrangements. It could be implemented almost immediately.

26.36 While it might appear that current purchasing power accounting would be simpler to implement for the vast majority of sole traders, we consider that the introduction of a different concept of profit, particularly one which has little relevance for business purposes, would cause unnecessary confusion which would be undesirable.

26.37 We conclude that business income should be determined for tax purposes on a basis which maintains intact the operating capability of the business entity. This is consistent with current cost accounting principles. Although an accounting standard exists which makes it mandatory for certain businesses to publish current cost accounts, there is as yet insufficient acceptance that this method is adequately tested and capable of general application. Until the accounting profession has confirmed the principles and practice of current cost accounting for universal application it would not be appropriate as a basis for a system of taxation. In these circumstances, we now consider how the tax system should be adapted in the interim so as to facilitate the development and application of improved accounting methods. Appropriate adjustments need to be made in respect of stocks, monetary assets and liabilities and depreciation.

Stocks

26.38 The costs of stock consumed during a period may, in certain

circumstances, be ascertainable by reference to individual items of stock. However, for the majority of enterprises, it is impossible to identify individual items sold and to match the revenue obtained against the price paid. A typical manufacturing company may carry thousands of items of stock purchased at different times and prices which may be combined or processed in different ways. For such enterprises, the calculation of the cost of stock consumed has to be based on conventional assumptions.

26.39 Under the historical cost convention, stocks on hand at balance sheet date are valued normally under the First In First Out (FIFO) convention. Although FIFO is the most widely used convention in Ireland, the Revenue Commissioners will accept certain other methods of valuation, provided they are used consistently by an enterprise. Under the historical cost accounting convention, realised holding gains arising from stock appreciation are included in the reported profit for the year. Until 1975, tax was charged in all cases on the full amount of the historical cost profit including these holding gains.

26.40 To mitigate the liquidity problems resulting from increasing stock values, stock relief was introduced in 1975 but was confined to companies engaged wholly or mainly in manufacturing, construction or farming, or in the sale of plant, machinery or material to those sectors. The relief was extended to unincorporated traders in the relevant sectors in 1976 with retrospective effect. At present, stock relief is given in respect of 75 per cent of the excess of the increase in the value of stocks over 20 per cent of net profit before the deduction of capital allowances. Farmers qualify for special relief.

26.41 We received a number of submissions which identified deficiencies in the existing system of stock relief. The main criticisms may be summarised as follows:

(i) The relief is available only to a limited section of the business community.

(ii) The relief only adjusts for the increased cost of maintaining stocks and does not take into account other items of working capital.

(iii) Movements in stock value are made up of two component parts, namely, volume and price. Any increase or decrease in trading stocks in an accounting period may be due largely to changes in volume rather than price. Stock relief does not take this into account.

(iv) The method of calculating relief, whereby increases in stock are reduced by 20 per cent of taxable profit and the restriction of the relief to the taxable profit before capital allowances of the accounting period after deducting capital allowances and losses carried

forward, may result in many business activities affected by inflation not obtaining relief.

(v) Relief is granted to each company in a group and there is no provision for grouping of stock relief which might be more equitable in certain circumstances.

(vi) Stock relief is calculated by reference to stock levels at two points in an accounting period, namely, the opening and closing days of the accounting period. The levels of stock at these dates may not be representative of the levels throughout the year.

(vii) Clawback provisions mean that the relief may only be a deferral of tax payable rather than a permanent relief. Stock relief does not recognise that, in times of rising prices, profits shown by historical cost accounts can be illusory to a greater or lesser extent depending on the composition of the assets employed in the business.

26.42 The Department of Finance and the Revenue Commissioners took a different view of the purpose of stock relief. They stated that

> "Advocates of current cost accounting have criticised the existing stock relief scheme because it does not differentiate between volume and price changes. Such criticism is valid only if the scheme is considered solely as a counter measure to inflation but not if the relief were looked on as a combination measure aimed at encouraging increased investment in working capital and at easing the pressure on cash flow caused by the inflated cost of basic stocks".

26.43 We do not regard the adjustment of the tax system to take account of the effects of inflation as an investment incentive. We consider that the whole tax system should be adjusted in a systematic way to take account of inflation. In line with this approach, we now consider how a system of stock relief or cost of sales adjustment should be implemented.

26.44 It would necessarily be more complex to operate a cost of sales adjustment based on a large number of different industry-specific indices for stock than a scheme employing a single index. The multiple index approach would require each business to identify the index appropriate to its particular activities. In some cases, businesses might need to apply different indices to different categories of stock. In others, quite diverse trading activities could be carried on within a single enterprise and this would raise the question of different indices for each of the different activities. Provision would also have to be made where the mix of trading activities in a business changed so that the original choice of index was no longer appropriate.

26.45 In the United Kingdom there are over 150 official indices measuring

changes in the price of stocks for particular industries. These indices are built up from the appropriate components of the wholesale price index, all of which were already well established at the time of the development of the special index numbers. They are based primarily on the prices of items produced in the United Kingdom for the home market and which, therefore, can be collected directly from United Kingdom manufacturers.

26.46 We asked the Central Statistics Office about the availability of official indices of the price of stocks and plant and machinery, which are specific to particular industries and business sectors. They informed us that

> "There are major difficulties in compiling detailed industry-specific price indices for this country comparable to those published in the United Kingdom. The major problem stems from the fact that a considerable proportion of the plant, machinery and materials purchased by manufacturing firms is imported (often directly), and other than materials imported regularly and continually by individual firms (from whom these input as well as output prices would have to be collected) there is no possibility of getting details of actual import prices on a continuous basis for index compilation purposes. A second major problem is that for the domestic manufactured or distributed products covered by our wholesale price index, the present level of response (i.e. number of respondents who are prepared to co-operate continuously and number of products which they price) to our monthly price inquiries do not allow us to publish more detailed indices. Because of the increasing resistance of businesses to statistical inquiries there is little likelihood that this situation will improve significantly in the short-term. Finally, in the case of plant and equipment there are very serious difficulties in compiling price indices because of the 'one-off' contract nature of most work and the level of detail which we will be able to publish here, even for domestically manufactured products, will always be limited.".[1]

26.47 We also discussed this question with the Revenue Commissioners who believed that there was a persuasive case on administrative grounds for the mandatory use of a single index to distinguish price changes from volume changes in stock figures. While the use of specific indices is desirable in principle, we accept that this is not feasible at present and we recommend that a single index be adopted. We consider that the Consumer Price Index provides a suitable measure of inflation in the long-term and that it would be appropriate to use it for the purposes of the cost of sales adjustment.

Basis of Adjustment

26.48 A cost of sales adjustment could be applied to stock values taken at a single point of time, for example, at the beginning of the accounting

[1] Letter of 11 March, 1981.

period. Alternatively, the relief could be based on the average value of stocks during the year. This would be an average of opening and closing stocks or an average calculated quarterly, monthly or more frequently.

26.49 In principle, an average provides a more representative figure of stock holding over the year. However, a simple average of opening and closing stock would not be sufficient and would not necessarily be more accurate than the use of the opening stock value by itself. To take account of businesses whose stocks fluctuate sharply, for seasonal or other reasons during the course of the year, stock valuations would need to be taken at intervals during the year. This would be complicated both for business and the Revenue Commissioners. If the rate of change of prices was uneven throughout the year, even this complicated procedure would not necessarily give an accurate result.

26.50 Opening stock is the simplest basis for the adjustment. The figure is available at the end of the previous accounting period which may help business to assess its potential tax liability for the coming year. This method of adjustment does not take account of changes in stock levels over the year, but such changes would be reflected in the cost of sales adjustment for the succeeding year.

26.51 In the light of these considerations, we recommend that a cost of sales adjustments be made on the basis of opening stock values.

26.52 So long as the tax system is not fully adjusted for the effects of inflation, any adjustment which provides relief in respect of an increase in stock values must necessarily include provisions for the withdrawal of the relief when it is no longer required for the purposes for which it was designed. Our proposals provide for the systematic adjustment of the tax system to take account of the effects of inflation. On this basis, it is appropriate that any relief provided under a cost of sales adjustment should represent a permanent relief rather than a deferral of tax.

Monetary Assets and Liabilities

26.53 SSAP16 provides for two adjustments in the current cost accounts to take account of the effect of price changes on monetary assets and liabilities. These are the monetary working capital and gearing adjustments. The monetary working capital adjustment complements the cost of sales adjustment by taking account of price changes as they relate to the remaining elements of working capital of the business. Monetary working capital consists of trade debtors plus cash needed for day-to-day operations less trade creditors. When prices are rising and debtors exceed creditors, the monetary working capital adjustment provides a further deduction from historical cost profits. If creditors exceed debtors, the excess reduces pound

for pound the amount on which the cost of sales adjustment is given. This reduction cannot exceed the value of stocks. Any excess is taken into the gearing adjustment. This adjustment abates the current cost adjustments in respect of depreciation, stocks and monetary working capital by the proportion which the net borrowing of the business bears to its net operating assets at their current cost values.

26.54 To apply the monetary working capital and gearing adjustments provided for under SSAP16, the business must distinguish between financial assets needed for day-to-day operations and other financial assets. It is also necessary to allocate borrowing between the two adjustments. The distinction in the treatment of monetary assets and liabilities according to the purpose for which they are held introduces an element of subjectivity into these adjustments which the tax system should seek to avoid. In the case of sole traders, it is often very difficult to distinguish between the assets held by the individual in his private as opposed to his business capacity. For example, the same bank account may be used for both purposes.

26.55 For these reasons, we favour a simpler approach. We consider that the monetary working capital adjustment should be confined to trade debtors and creditors, thereby excluding financial assets and liabilities. We recognise that this arrangement could lead to window-dressing at the end of the year. However, this also applies in relation to the existing stock relief and as far as we have been able to ascertain this has not been abused significantly. We propose therefore that a cost of sales adjustment be given on the basis of stock values, plus trade debtors minus trade creditors, at the beginning of the accounting period.

26.56 We consider that tax should be charged on the profit of the entity before deduction of interest. On this basis, it would not be appropriate to make an adjustment in respect of gearing of the type envisaged in SSAP 16 in computing profits for tax purposes. Our proposals for the taxation of interest received are set out in Chapter 11 where we recommend that interest receipts should only be charged to tax to the extent that they exceed the rate of inflation. Consideration should be given to imposing a withholding tax on payments of interest to the extent that they exceed the rate of inflation. This tax would satisfy the liability of the recipient of the interest and would be available as a credit against the tax liability of the entity in the same way as the withholding tax on distributions which we recommend in Chapter 28.

Depreciation

26.57 Depreciation may be defined as the exhaustion, wear and tear and obsolescence of assets used in the production of income. The exhaustion of an asset in the course of its use is one of the elements of cost in a business

enterprise. Therefore, to arrive at a proper estimate of income an appropriate proportion of the total depreciation relating to an asset must be charged against income for each year of the estimated useful life of the asset in order to match revenue earned in a particular year against that part of the value of assets related to the generation of that revenue. The existing position in relation to the treatment for tax purposes of depreciation, together with a note on its historical development, is set out in Appendix 20.

26.58 There is no universal agreement regarding capital allowances in respect of depreciation of assets. Kaldor argues as follows:

> "Looking at the matter from the point of view of equity alone, it is clear that an allowance for capital wastage without a corresponding charge being imposed on capital appreciation is quite indefensible. Even with a system of taxation on realised capital gains, capital wastage ought only to be taken into account in the form of a corresponding allowance for capital losses, which means that the allowance should be given as and when the capital loss resulting from wear and tear and wastage is actually realised".

26.59 The Royal Commission on the Taxation of Profits and Income in its final report in 1955 drew attention to two different views on the question of capital allowances:

> "To some they appear as an allowance for the loss of capital, made good at the expense of taxable profits, inconsistent with an income tax system that affects to ignore movements of capital, and justified only on economic grounds as a stimulus to desired investment. To others they are an inescapable element in the very conception of a trading profit, and due to the taxpayer less as a concession to his activity in the public interest than as a necessary charge that must be entered before he can be said to possess a taxable profit at all".[4]

26.60 It is clear that under our comprehensive concept of income which includes accretion of capital as income, there is no difficulty in principle in allowing deductions for capital wastage. However, the question still remains whether or not it is appropriate to allow for depreciation on an accruals basis when gains are taxed on a realisations basis only. We believe that since the use of assets is a prerequisite to the production of goods and services for sale, it is inescapable that the depreciation on such assets as it accrues should, in principle, be allowed as a deduction in computing the income from the sale of those goods and services.

26.61 In considering the question of relief in respect of depreciation of assets, two main issues must be addressed:

---

[3] *Indian Tax Reform* N. Kaldor 1956 page 76.
[4] paragraph 328.

(i) The basis on which the relief is given.

(ii) The definition of the classes of expenditure which qualify for relief and the amount of relief to be given in normal circumstances.

Basis of Allowances

26.62 Broadly speaking, SSAP16 provides for a depreciation adjustment to allow for the difference between the depreciation charged on a historical cost basis and depreciation at current replacement cost. To do this, the business has to estimate the length of the remaining useful life of the asset to determine its gross current replacement cost. In the case of plant and machinery, gross current replacement cost is normally to be found by adjusting the original cost by reference to the movements in a relevant index. Regard may be had to other factors such as actual purchase prices or suppliers' price lists where these are readily available. In appropriate cases, provision may be made by reference to the cost of a modern equivalent asset rather than by reference to the replacement of the particular asset in question. In the case of land and buildings, current replacement cost is generally to be arrived at by professional valuations, normally at intervals not exceeding five years. In the intervening periods, the figure is to be adjusted as the directors consider necessary and in the light of any professional advice or other evidence available.

26.63 The current cost depreciation charge for the year is confined to the proportion of the gross current replacement cost of the asset consumed in that year. Any "backlog" depreciation attributable to earlier years due to a higher estimate of current replacement cost is not charged to the profit and loss account but to the current cost reserve. Any difference between the net current replacement cost and the disposal price is taken to the profit and loss account.

26.64 In the absence of authoritative guidance on the question of useful asset lives and on other aspects of depreciation, the allowance of depreciation as charged in current cost accounts would introduce an unacceptable degree of subjectivity into the tax system. Businesses would have a wide measure of discretion in deciding their own depreciation policy, subject only to the legal requirement (in the case of companies) for accounts to present a true and fair view. For this reason, and pending developments in generally accepted accountancy practice, we recommend that for taxation purposes deductions in respect of depreciation continue to be given in the form of capital allowances.

26.65 To obtain a true estimate of income derived from business activities (under a comprehensive definition of income) it would be necessary to abolish free or accelerated depreciation on plant and machinery and on

other fixed and working assets and to replace it by "true" economic depreciation. Depreciation rates intended to spread the difference between the cost of the asset and its residual value over its useful working life would be applied to original cost (if the straight line method were used) or to written-down value (for the reducing balance method). But each year the original cost or written-down value would be increased by the inflation factor corresponding to the average rate of inflation and not to a price index for the particular asset in question. In this way, depreciation would be given not at historical cost but at indexed cost and real holding gains on would be counted as income for tax purposes as and when they were realised.

26.66 We recommend that this general method be used in respect of assets. We leave open the question of accelerated capital allowances for incentive purposes until a later report. The index which we recommend for adjustment purposes is the Consumer Price Index because

(i) this is acceptable as a general measure of price changes;

(ii) specific indices are not available, and

(iii) it would allow simplification in computing balancing charges where the sale price exceeds the original cost (under our proposals for a single rate of income tax).

26.67 We recognise that this system may prove relatively complex for some businesses in that it will require the maintenance of asset registers broken down by year of acquisition. However, we see little alternative if business income is to be correctly measured in periods of inflation.

26.68 When capital allowances are indexed, the calculation of balancing allowances and charges should take the full proceeds of sale into account, even where they exceed the original cost. This recommendation depends on income and capital gains being subjected to the same rate of tax.

26.69 Where income tax and capital gains tax are not levied at the same rate (as may arise in the transitional period to a single rate of income tax), any real increase in the value of the original asset should be charged at capital gains tax rates and the calculation to compute the balancing charge would limit the sale proceeds to the original indexed cost. Examples of the calculations required are given in Appendix 21.

Qualifying Expenditure

26.70 In this section, we consider the classes of expenditure which would qualify for capital allowances. At this point, we do not consider whether depreciation should be increased as an incentive for investment in particular types of assets but merely the appropriate amount of normal depreciation.

26.71 The criticisms of the existing system of capital allowances raised in submissions fell into two main categories — those which pressed for extensions to the system and those which argued for a restriction on the amount of allowances given. The latter implied in certain cases that deductions in respect of normal depreciation of assets are not wholly legitimate. We believe that under a system which taxes all forms of income equally, accurate deductions in respect of normal depreciation are wholly justifiable and should not be restricted arbitrarily.

26.72 Many improvements in capital allowances which do not relate to the extension of incentives were suggested in submissions. These were that capital allowances should be extended to

(i) land;

(ii) commercial buildings;

(iii) residential property, and

(iv) licensed premises.

Other improvements suggested were that

(i) the discrimination between the occupiers and lessors of industrial buildings in the matter of capital allowances should be removed;

(ii) allowances on second-hand industrial buildings should be based on the price paid by the purchaser rather than the residue of previously unallowed expenditure, and

(iii) the limit on the capital allowances available on motor vehicles should be increased.

Land

26.73 Land is not normally regarded as a wasting asset. We cannot recommend any allowance for depreciation in these circumstances. Changes in the value of land may be more appropriately taken into account for capital gains tax purposes.

Buildings

26.74 Industrial buildings qualify for capital allowances at present whereas commercial buildings do not. Buildings present special problems in relation to depreciation. Whereas structures and building services depreciate in value over their useful lives, this may be more than offset by increases in site value leading to an increase in the combined real value of the structure and site. In principle, we consider that capital allowances should be allowed in respect of the depreciation of the structure on the basis of indexed cost.

26.75 There are difficulties inherent in arriving at an acceptable estimated useful life of buildings in that subjective judgements are involved and decisions taken may vary from company to company holding similar assets. In cases in which the actual asset life differed significantly from the prescribed life, an element of instability would be introduced into profits. This would be undesirable.

26.76 For this reason, we favour a simpler approach. An alternative method of allowing for any capital wastage in certain business assets is not to allow any annual wear and tear allowance in respect of them but to make them chargeable assets for capital gains tax purposes and to take account of any change in their real value by reference to original cost when the assets are realised. Any real loss would then be allowable against profits. We consider that this treatment is appropriate only for assets such as buildings. This is because the declining real value of buildings tends to be more than offset by the increasing real value of their sites. When income tax is charged at a single rate, there is no difference in the ultimate incidence of the tax. Our proposed treatment has the advantage of being simpler for both the taxpayer and the Revenue Commissioners. We consider that this treatment should apply to all buildings, except those which are custom-built for specific industrial purposes. These should be classified as plant and capital allowances granted accordingly.

Lessors and Occupiers of Industrial Buildings

26.77 In 1978, a distinction was introduced for the first time between owned and leased assets, in that free depreciation was provided for owner-occupiers of industrial buildings, while lessors of such buildings remained entitled to initial and annual allowances of 50 per cent and 4 per cent respectively. This distinction was adopted in an effort to limit what was seen as tax avoidance through the use of leased assets.

26.78 In our view, there is no economic justification for the distinction between owner-occupiers and tenants. Development of new industrial estates takes place primarily by lessors who then lease the property to the industrial user. We recommend that no distinction for tax purposes be made between leased assets and assets occupied by the owner.

Allowance on Second-hand Industrial Buildings

26.79 Annual allowances on industrial buildings are based on the residue of previously unallowed expenditure where buildings are purchased second-hand. It was submitted to us that this is the cause of much practical difficulty and is anomalous when compared with the legislative provisions regarding second-hand plant.

26.80 The Department of Finance and the Revenue Commissioners took an opposing view:

> "The present system is convenient for both Revenue and taxpayers; for the purchaser of a second-hand building there is certainty about his entitlement to allowances and the system is consistent with a policy of encouraging investment in modern industrial buildings".

26.81 There is little doubt that the capital allowances available to a purchaser of a second-hand industrial building influence the price payable to the vendor. For this reason, we consider that equity, efficiency and simplicity would be better served if no capital allowances were granted on second-hand industrial buildings, but that gains or losses in real terms on such assets were taken into account for capital gains tax purposes. Any postponement in relief will be reflected in a reduced price payable to the vendor who can claim tax relief for this reduction in the form of a higher balancing allowance or reduced balancing charge.

Motor Vehicles

26.82 At present, capital allowances on motor vehicles are allowed at the rate of 20 per cent per annum on the written down historical cost. If the purchase price of the motor vehicle is in excess of £3,500, the allowance is reduced to what it would have been if the purchase price of the vehicle were £3,500.

26.83 We consider that capital allowances on motor vehicles should be allowed in full to the business entity. Any limitation on the allowability of motor expenses should be treated as a benefit-in-kind to the proprietor or employee who enjoys the use of the motor vehicle.

Asset Lives

26.84 A change to indexed capital allowances raises the issue of the length of the period over which plant and machinery should be depreciated. At this stage, and bearing in mind our comments in paragraph 26.64, we see little alternative save that some arbitrary but reasonably realistic write-off periods for broad classes of assets should be prescribed by statutory regulation.

Losses

26.85 Under existing legislation, losses are carried forward and backwards at their historical amounts. If the period of carry forward is lengthy, the benefit of the losses is reduced as is shown in Appendix 22. The position is similar for capital allowances carried forward. A tax system which is neutral

with respect to inflation should provide for indexation of losses and capital allowances carried forward. We consider that the appropriate index for this purpose is the Consumer Price Index. It follows that losses carried backwards should be indexed downwards in time of inflation.

Recommendations

26.88 Accountancy is in the process of evolving and developing from the traditional historical cost convention which is widely regarded as inadequate and misleading. Although an accounting standard exists which makes it mandatory for certain businesses to publish current cost accounts, there is as yet insufficient acceptance that this method is adequately tested and capable of general application. Until the evolution has reached a point at which the accounting profession has confirmed the principles and practice of current cost accounting for universal application, it would not be appropriate as a basis for a system of taxation. However, we consider that the tax system should facilitate, rather than inhibit, the evolution of an improved accounting method. Against this background, we recommend that profits for tax purposes be computed on the following basis:

1. The cost of sales adjustment should be made by reference to stocks plus debtors, minus creditors as shown in the opening balance sheet and calculated by reference to changes in the Consumer Price Index.
2. Taxation should be assessed on the operating profit of the entity before remunerating holders of debt and equity capital.
3. Capital allowances for taxation should be retained in place of any charge for depreciation in the accounts of a business.
4. Capital allowances computed on the original cost of the asset should be indexed in line with changes in the Consumer Price Index.
5. Balancing allowances and charges should take the full proceeds of sale into account and be computed by reference to the written down value indexed for the period from purchase to sale.
6. No capital allowances should be introduced for land.
7. To ease administration, allowances for capital wastage in respect of all classes of buildings should be allowed only when the buildings are disposed of. All these assets should be regarded as chargeable assets for capital gains tax purposes. Buildings which are custom-built for specific industrial purposes should be classified as plant and capital allowances granted accordingly.
8. The distinction in the capital allowances granted to owner-occupiers and lessors of industrial buildings should be removed.
9. Capital allowances on motor vehicles should be allowed in full to the business entity.

10. In the case of assets which qualify for capital allowances, reasonably realistic write-off periods for broad classes of assets should be prescribed by statutory regulation.

11. Losses and capital allowances carried forward or backwards should be indexed upwards or downwards as appropriate by reference to changes in the Consumer Price Index.

CHAPTER 27

TAXATION OF COMPANY INCOME

Introduction

27.1 In this chapter we set down the general system of taxation which should apply to company income. Temporary departures from this general system may be justified in special circumstances to achieve economic or other objectives. We recommend that tax still be collected at the company level but that full imputation should be given for tax so paid.

27.2 We note that almost all the problems in the area of company taxation arise because company profits are charged to tax at a flat-rate, while income tax on individuals is levied at progressive rates. This results in the use of companies for tax avoidance purposes. Distortions also arise because, under such a system, it is impossible for taxation to be neutral in its treatment of retentions and distributions. Because we recommend that all income, including company income, be charged to tax at the same single rate, our general system is able to avoid all these problems.

The Corporate Sector

27.3 The number of companies in Ireland has been increasing steadily in recent years. This can be seen from Table 28 which gives the total number of companies having a share capital on the Register of Companies.

TABLE 28

Number of Companies having a Share Capital on the Register, except Those in the Course of Liquidation or Removal from the Register.

Date	No. of Private Companies	No. of Public Companies	Total
31 December, 1974	35,739	384	36,087
,, 1975	38,730	350	39,080
,, 1976	41,434	354	41,788
,, 1977	44,069	338	44,407
,, 1978	48,230	339	48,569
,, 1979	53,869	339	54,208

Source: Report by the Department of Industry, Commerce and Tourism, 1979 under the Companies Act. Annex No. 3. Prl. 8962.

27.4 The number of corporation tax assessments made by the Revenue Comissioners is given in Table 29.

TABLE 29

Assessments Made to Corporation Tax

Year	No. of Assessments
1976	18,189
1977	21,900
1978	25,427

Source: Annual Report of the Revenue Commissioners, 1978 Prl. 8470 Table 94.

27.5 We asked the Revenue Commissioners why there was such a difference between the number of assessments and the number of companies registered. They replied that about 11,000 companies were active but did not have profits chargeable to corporation tax. Examples of these were loss-making companies, companies having franked investment income only, property-holding companies or companies whose income was exempt from tax. The balance is made up of dormant companies or new companies which have not yet commenced to trade.

Systems of Company Taxation

27.6 Under a system which charges tax on both the income accruing to individuals and companies, it is necessary to choose one of two possible types of relationship between company tax and personal income tax. In the first place, the whole of the company's profits may be charged to corporation tax, whether or not the profits are retained or distributed in dividends, and the dividends may, in addition, be subject to personal income tax in the hands of individual shareholders. This system, which is known as the classical or separate system, favours retained profits, unless it were possible to charge a fully effective capital gains tax (on accrued gains at income tax rates) on the increased value of the company's shares due to the increase in its undistributed profits and in its underlying assets.

27.7 In order to remove or mitigate this discrimination against the distribution of profits, a second type of relationship between company and personal taxation may be chosen. This may take two basic forms:

(i) a *two-rate system,* under which there is one rate of corporation tax on undistributed profits and another (lower) rate on distributed profits, or

(ii) an *imputation system* (such as the current Irish system described in

Chapter 25) under which all profits are charged to corporation tax, but in which dividends are given a tax credit which can be either repaid or set against liability to personal taxation.

Desirable Attributes of a General System of Company Taxation

27.8 A satisfactory general system of company taxation should comply as far as possible with the following domestic requirements:

(i) It should be neutral as between the choice of business organisation and in its treatment of retained and distributed profits.

(ii) It should be equitable in that the tax paid by shareholders should be equivalent to that payable on other income.

(iii) It should be consistent with overall economic policy in bringing forward the desired level and pattern of investment.

(iv) It should be efficient in terms of administrative and compliance costs.

It is, of course, extremely difficult to devise a system which meets all of these criteria since there may be a conflict between them in certain circumstances.

Neutrality

27.9 The basic proposition underlying the notion of neutrality is that the taxation system should not impose different tax burdens on income which arises through different types of business organisation. In other words, the task is to devise a system that will charge the same tax on a trader whether he carries on his business on his own or whether he incorporates it. The level of taxation on company income must, therefore, be considered in conjunction with the tax treatment accorded to businesses operated by individuals or partnerships.

27.10 If the combined effects of the personal income tax, capital gains tax and corporation tax are not neutral between different forms of business organisation, this will have economic effects. Among the items which may be influenced are investment decisions, decisions about the retention or distribution of company profits and the raising of finance through the issue of shares or debentures. The tax system may also discriminate between investment in fixed-interest securities or shares and between investment for income or for capital gain.

27.11 If income accruing to companies is over-taxed relative to what it would be if it accrued to other forms of business organisation, inefficiency will result. To the extent that companies will pass on the additional

corporation tax in the form of higher prices for their products or through lower prices for their purchases (including labour), consumers and suppliers will buy fewer of these goods, or switch to cheaper sources (imports) or buy fewer other things than they would otherwise be able to buy. This is wasteful. To the extent that companies do not pass on the tax through these price changes, their rate of return on investment is reduced and the allocation of resources is distorted. Thus, an additional tax on company income distorts the allocation of resources, whether or not the tax is passed on. Removal of the distortions created by the over-taxation of company income would increase the overall level of welfare by improving the allocation of resources.

27.12 If income accruing to companies is under-taxed relative to what it would be if it accrued to other forms of business organisation, inequity will result since it will be possible for certain individuals to arrange to receive their income through companies solely for purposes of tax avoidance.

27.13 We have already noted that a system of company taxation which is not neutral can influence business decisions. We now look in some detail at the way this can happen with regard to

(i) the distribution of company profits;

(ii) the quality of investment;

(iii) the volume of private savings, and

(iv) new fund-raising by companies.

Distribution of Company Profits

27.14 The encouragement of investment by the corporate sector is a major aim of Government policy. General or selective measures related to the granting of depreciation allowances or tax reliefs on profits arising from certain activities are the main tax policy instruments used to achieve this objective. However, the relative tax treatment of retained and distributed company profits may also have an influence in this area.

27.15 If distributed profits are charged at a higher rate of tax than undistributed profits, this may lead to greater retention of profits in the company. The level of tax on capital gains has an important influence here. Shareholders may prefer the retention and reinvestment of profits by the company, if the rate of tax on capital gains on increases in share values is less than that borne by distributed profits.

27.16 The existing Irish system of company taxation is not neutral between retained and distributed profits. The total burden of tax imposed on company income is the sum of the tax imposed first at the company

level and then at the shareholder level, when income is distributed as dividends. Table 30 shows the total tax paid on company income distributed to shareholders depending on the marginal rate of tax of the shareholders.

TABLE 30

Combined Effective Rate of Corporation Tax and Income Tax at 1981/82 Rates on Retained and Distributed Profits*

Marginal rate of income tax of Shareholder	Normal rate of tax on		Extent of over-taxation of	
	distributed profits	retained profits	distributed profits	retained profits
%	%	%	%	%
0	21.4	45	21.4	45
25	41.1	45	16.1	20
35	48.9	45	13.9	10
45	56.8	45	11.8	–
55	64.6	45	9.6	−10
60	68.6	45	8.6	−15

*The figures in this table do not take account of the situation in which no tax is paid in respect of profits due to incentive or other reliefs but distributions from these profits carry a tax credit or of the effect of capital gains tax. They assume that corporation tax is payable at a rate of 45 per cent and that there is a tax credit of 30/70 ths on distributions.

27.17 Table 30 shows that income distributed to shareholders from companies bears a higher burden of tax than it would if it accrued to them directly. The extent of this over-taxation declines as the marginal rate of personal taxation increases. The discrimination is therefore at its greatest in the case of shareholders who are exempt from tax, such as pension funds and those with low incomes. Table 30 also shows that in the case of individuals liable to tax at the higher marginal rates of personal income tax, there is an incentive to shelter profits in companies.

Quality of Investment

27.18 In theory, the most efficient use of the total investment funds available is likely to be achieved if companies maintain high distributions and submit themselves to the discipline of a perfect capital market when they need funds for new investment. This will lead to funds being directed to the most efficient companies and investment projects. A greater proportion of investment financed from retained profits may be less efficient.

27.19 The considerations involved in this issue have been summarised by the Harold Wilson Committee which noted that

> "the disadvantage of raising equity in the market as against retaining profits, from the directors' point of view, is that they tend to have to

commit themselves more about why they need the money and whether the existing equity will be diluted; and they therefore need to feel more certain that their minimum rate of return will be earned and that the returns will come in quickly enough for there to be no reduction in dividend on the increased capital or even their earnings cover for that dividend".[1]

27.20 Empirical evidence on the question of whether the distribution or retention of profits affects the efficiency of investment is inconclusive. The state of development of the capital market is also relevant. We discussed this issue of the tax treatment of retained and distributed profits with officials of the Central Bank of Ireland who did not favour the existence in the long-term of any general tax preference for retained profits on the grounds that this might impede the development of capital markets. They suggested that direct incentives or grants were likely to be much more effective in increasing the efficiency of investment than general tax measures which would, of necessity, be indiscriminate.

27.21 Retained profits are a major source of equity finance which is a key resource. Equity finance gives independence to a firm. If interest cover is ample, lenders accept the firm's judgement of risks. If interest cover is thin, lenders remember that if the firm goes bankrupt, they lose all their money, while, if it does exceptionally well, they still only get their interest. They become nervous about risks or about profits which, however potentially large, are long postponed. A high proportion of equity finance enables firms to take risks. In general, the more specialised an investment, the longer its term and the higher the risk of loss, then the greater will be its need to rely on equity finance.

27.22 The question then arises whether or not the tax system should encourage the retention of profits by imposing a higher tax charge on, or attaching a lower tax credit to, distributions. It is conceivable that a higher rate of tax on distributions encourages the distribution of profits as companies attempt to maintain the income of shareholders in post-tax terms. We have seen no convincing evidence that a lower rate of tax on retained earnings is desirable on the grounds that it encourages retentions and increases the efficiency of investment.

The Volume of Private Savings

27.23 It does not follow that a change to a system which is neutral between retained and distributed profits will increase the level of distributions. Should it do so, a higher level of distributions may result, at least in the

[1] *Report of Commission to Review the Functioning of Financial Institutions* HMSO June, 1980 Cmnd. 7937, paragraph 515.

short-run, in a reduction in the total amount of private savings. In the longer-run, this may be offset by the realisation of gains from a more efficient allocation of resources. In the case of dividends paid to non-residents, the national loss may be absolute unless the funds are re-invested in Ireland. In the case of residents, the reduction in the pool of savings will depend on the extent to which shareholders receiving higher dividends increase their consumption.

27.24 The precise effect of these factors on the volume of private savings will also depend on the overall level of taxation and the effective rate of tax on dividends. In a purely domestic context, a change in the tax system, which led to greater distributions, would be expected to lead to a fall in private savings. However, to the extent that shareholders base their consumption decisions on total income, including unrealised capital gains arising from the retention of profits, there may be no reduction in private savings if distributions are increased. The forces which influence the level of savings are so complex that it is difficult to quantify the effects of the influences we have just discussed. We see no reason to discriminate against the distribution of profits by companies on the grounds that this would increase savings.

Raising of New Funds by Companies

27.25 The nature of funds required by a business depends on the type of the business, its existing capital structure and the cost and availability of funds of different kinds. Some larger companies use systems of overall financial programming, whereby neither particular forms of finance nor particular capital raising operations are related to specific projects. Within this broad programme, such companies are usually fairly flexible regarding the composition of their financial liabilities, subject only to prudent gearing considerations. In most cases, companies try to give themselves freedom of manoeuvre by setting stricter internal gearing criteria than those applied by outside institutions.

27.26 The present tax system is clearly not neutral as between equity and debt financing. Company income used to pay debt interest is not taxed at the company level, but only under the personal income tax in the hands of the lender. As indicated in Table 31, this produces a bias in favour of investment in debentures for all shareholders with marginal rates of below 50 per cent and a bias in favour of equity investment in higher retention companies for high-income shareholders.

27.27 The relative encouragement given to debt capital as a result of the allowance of interest payments as a deduction for tax purposes is, in practice, subject to some constraints. Companies have to have regard to the need to maintain an adequate ratio between debt and equity capital. In addition, the commitment to service borrowing must be met, while divi-

TABLE 31

Combined Rate of Company and Personal Income Tax under Present System by Shareholders' Marginal Rate of Tax and Proportion of Profits Retained

Marginal rate of income tax of shareholder	Combined company and personal tax as a percentage of company profits, assuming proportion of profits retained is				
	%	%	%	%	%
per cent	0	25	50	75	100
0	21.4	27.3	33.2	39.1	45.0
25	41.1	42.1	43.0	44.0	45.0
35	48.9	47.9	47.0	46.0	45.0
45	56.8	53.8	50.9	48.0	45.0
55	64.6	59.7	54.8	49.9	45.0
60	68.6	62.7	56.8	50.9	45.0

Notes

(1) The normal company tax rate is taken to be 45 per cent. The tax credit on distributions is taken to be 30/70 ths of the net distribution.

(2) The personal tax rates shown in column 1 are the rates in force for 1981/82. The figures are calculated on the basis that the amount of company profits attributable are modest enough to be taxed at the one marginal rate.

dends vary according to circumstances. The amount of equity funds raised by non-governmental bodies on the domestic capital market is relatively low. This is shown by the figures in Table 32.

TABLE 32

Funds Raised by Non-Governmental Bodies through Issues of Marketable Securities on the Domestic Capital Market

Year	Amount
	£m
1973	16.4
1974	10.2
1975	18.2
1976	18.7
1977	25.7
1978	18.5
1979	48.8
1980	3.3
1981	110.0

Source: The Stock Exchange — Irish.

27.28 We consider that the tax system operates in a haphazard way in influencing the relative attractiveness to companies of equity and debt finance. This is undesirable. Companies should be free to choose the form of finance best suited to their needs and this should not be distorted by tax considerations. For this reason, the tax system should be neutral between equity and debt finance.

Considerations of Equity

27.29 The taxation of company income should also be equitable. This is related to the idea of neutrality discussed earlier, even though the two notions have their justification on different grounds. The need for equity arises from considerations of justice, while neutrality is called for on the grounds that it contributes to the achievement of economic efficiency. Equity would be achieved under a tax system in which all individuals holding interests in companies were charged to tax on the accrued net gains on the same basis as all their other income. Therefore, a system which is neutral with regard to the taxation of company income will also be equitable in its treatment of individuals who receive income through the medium of companies.

Effect on Investment

27.30 The system of company taxation should be consistent with overall economic policy in establishing the desired level and pattern of investment. This is particularly important when set against the background of the need to develop the Irish economy and to generate higher levels of employment. This requires that the system of company taxation should be such as to encourage domestic investment and attract foreign investment. The system of company taxation is less important in this area than the rate of tax, the level of investment grants and other incentives. However, we believe that a system which conforms to the requirements of neutrality and removes any element of double taxation of corporate income will facilitate investment better than a system which does not meet these requirements.

Criticisms of Present System

27.31 We received relatively few submissions dealing with the appropriate system of taxation of income arising to companies. Reference is made in Chapter 31 to the views expressed by the Consultative Committee of Accountancy Bodies — Ireland, which held that the existing system is not neutral between retained profits and distributions, between incorporated entities and unincorporated entities and between salaries and dividends paid by companies. The tax treatment of incorporated and unincorporated entities is examined in Appendix 23.

27.32 We have already seen that the present system is not neutral between retained and distributed profits. The tax system also favours income taken out of companies in the form of directors' remuneration relative to the treatment accorded to dividend income. This is because of the element of double taxation of dividend income.

Recommended System

27.33 To achieve neutrality between the tax treatment accorded to retained and distributed profits and between earnings taken out of companies in the form of salaries and dividends, we recommend that the rate of imputation on company distributions be increased to 100 per cent of the underlying corporation tax.

Evaluation of Proposed System

27.34 The system which we propose meets in large measure the domestic requirements which we have set for a system of corporation tax. It achieves greater neutrality between retained and distributed earnings than the present system and is equitable in that it avoids double taxation of dividend income. These results are not achieved by alternative systems of company taxation. The question of neutrality between the tax payable by different forms of business organisations largely depends on the relationship between the rate of corporation tax applied to retained earnings and the rates of tax charged on personal income. Neutrality in this respect is achieved under our proposal that all income including income arising to companies be charged to tax at a single rate.

Recommendations

27.35 We make the following recommendations:

1. An imputation system of company taxation should be retained.
2. The rate of imputation should be increased to 100 per cent of the underlying corporation tax.

CHAPTER 28

OTHER ASPECTS OF COMPANY TAXATION

Introduction

28.1 In this chapter we examine certain aspects of the taxation of profits arising to companies. These include the appropriate rate of company tax, the question of an advance corporation tax, the payment of tax by companies, the treatment of small and closely-held companies and the surcharge on the undistributed income of certain companies.

The Rate of Company Taxation

28.2 Under the full imputation system which we have recommended, the tax treatment of dividends would be neutral compared to income arising to individuals which did not pass through the medium of a company. However, a number of problems arise if company tax is charged at a flat rate while income tax is charged at progressive rates.

28.3 If the maximum rate of personal taxation is high in comparison with the rate of company taxation, there will be a tendency for companies, especially close companies, to retain funds in excess of the requirements of the business. There are two possible approaches in this situation. Firstly, the rate of corporation tax may be fixed at the highest rate of personal taxation. This would encourage the maximum distribution of profits which could then be re-invested at the shareholders' discretion. Alternatively, the rate of corporation tax could be fixed at approximately the weighted average marginal rate of all shareholders. This is a rough-and-ready approach but one which may offer the best prospect of achieving a reasonable balance between the desire of high-income shareholders for high retentions and the desire of low-income shareholders for high distributions. We believe that the most satisfactory solution is to charge income tax and corporation tax at a single rate, allowing full imputation at shareholder level for any tax borne at the company level. Any alternative is a less satisfactory solution.

Advance Corporation Tax

28.4 Submissions argued that the absence of an advance corporation tax (ACT) has led to a substantial loss of revenue in many instances. The loss

occurs because the present system frequently results in tax being repaid, or credited against liability, where no tax has been paid in the first instance. This anomaly arises where dividends which carry tax credits are paid by companies out of profits which, because of various reliefs, such as accelerated capital allowances and stock relief, are effectively exempt from tax. As a result, in certain instances, the Irish Revenue Commissioners repay tax to charities, exempt shareholders and United Kingdom shareholders which has never been paid to the Irish Exchequer. One solution put forward was that a company would pay to the Exchequer advance corporation tax equal to the tax credit applicable to any dividend which it pays. Any ACT payable would be allowed against the tax payable on the company's own profit.

28.5 This issue was raised also by The Institute of Taxation in Ireland which recommended that the present anomaly whereby a shareholder may receive repayment of a tax credit, where the company paying the dividend has not, in fact, paid tax, should be removed. The Institute stated that "the level of tax credit available to the shareholder should, in principle, be related to the tax borne by the company on the income out of which the dividend is paid".

28.6 The Institute strongly opposed an advance corporation tax on the grounds of its adverse effect on the cash flow of companies.

28.7 The implications of introducing an advance corporation tax may be explored by considering the following simple example. Take the case of a company which is not liable for tax because its capital allowances exceed book depreciation. Under the existing system, if the company makes a distribution of £70, this carries a tax credit of £30 which has never been paid. We now compare the existing system with the two options mentioned earlier.

	Existing System	ACT	Reduced Tax Credit
Net distribution	70	70	70
Tax credit	30	30	Nil
Gross income of shareholder	100	100	70
Tax credited or repaid	30	30	Nil
Tax paid by company	Nil	30	Nil
Loss to Revenue	30	Nil	Nil
Net income of shareholder liable to income tax at:			
top rate (60 per cent)	40	40	28
standard rate (35 per cent)	65	65	45.5

28.8 Under the existing system, the Exchequer is at a loss of £30. Under both the alternative systems, the loss to the Exchequer is reduced to nil, and this difference must either be financed by the company or the shareholder. If the company maintains the same net distribution, the difference is financed by the company under the ACT system and by the shareholder under the alternative system. However, if the company wishes to maintain its cash flow under the ACT system it may reduce its net distribution so that the total of ACT and the net distribution is the same as before. The effect of doing this is as follows:

	ACT	
Net distribution	49	
Tax credit	21	
Gross income of shareholder	70	
Tax credited or repaid	21	
Tax paid by company	21	
Loss to Exchequer	Nil	
Net income of shareholder liable to income tax at:		percentage reduction in income
top rate (60 per cent)	28	30
standard rate (35 per cent)	45.5	30
exempt	70	30

28.9 This shows that the company can shift the burden of the additional tax payable with ACT by reducing the amount of its net distributions. The reduction in net income is borne uniformly by shareholders, regardless of their marginal rate. For this reason, we do not accept that the introduction of ACT need have an adverse effect on the cash flow of companies. Accordingly, we recommend that a withholding tax be introduced in the case of all companies liable to corporation tax at a rate equivalent to the tax credit on the dividend. In recommending this system, we have taken account of the administrative advantages which arise from the effective deduction of tax at source by the company. The withholding tax would be credited against the corporation tax liability of the company.

Payments of Tax by Companies

28.10 Companies are required to pay corporation tax in two instalments. With effect from accounting periods ending on or after 6 April, 1981, the first payment of tax is due six months after the end of their accounting period, while the second instalment is due three months later. In the case of most companies which were within the charge to income tax for the year 1975/76, before the introduction of corporation tax, the first payment of tax is due six months after the end of the accounting period, whereas the second is due anything up to nine months later. The differences between

old and new companies in the matter of payment of corporation tax are set out in Table 33.

TABLE 33

Due Dates for Payment of Corporation Tax*

Accounting period for year ended	New Companies	Old Companies
31 March, 1982	1 October, 1982 1 January, 1983	1 October, 1982 1 October, 1982
30 June, 1982	1 January, 1983 1 April, 1983	1 January, 1983 1 July, 1983
30 September, 1982	1 April, 1983 1 July, 1983	1 April, 1983 1 July, 1983
30 December, 1982	1 July, 1983 1 January, 1983	1 July, 1983 1 July, 1983

*The normal period of grace of one month before interest is charged applies.

28.11 The present arrangements for payment of tax by companies are unsatisfactory. All companies should be required to pay tax on the same basis. In addition, in periods of inflation the existence of a lag between the payment of tax and the earning of profits or income to which that tax is related confers an advantage on the taxpayer. For this reason, we recommend that the system of payments of tax which we recommend in Chapter 31 for self-employed persons should be applied also to companies.

Transitional Arrangements

28.12 The system we favour would require companies to pay tax due on the same basis as self-employed individuals. This would require the advancement of the date of payment of tax by companies. We recommend that these changes be phased in by advancing the dates on which companies pay tax by a maximum of three months per year.

28.13 We cannot accept the argument that this proposal is undesirable because of its effect on the cash flow of companies. The present arrangements constitute a hidden subsidy to business carried on through the medium of companies and result in a lack of neutrality between, for example, incorporated and unincorporated retail business. If it is necessary to help specific sectors, particularly the exposed market sector, this should be done by specific measures rather than by generalised and inefficient hidden subsidies.

The Taxation of Small Companies

28.14 In Ireland, small companies, defined as those with profits of up to £25,000, pay a lower rate of corporation tax. There is marginal relief for

companies with profits between £25,000 and £35,000. When this relief was last increased in 1978, the Minister for Finance said in his budget statement:

> "I have been very conscious of the need to do everything possible to help small firms. It is most desirable that the possibilities for growth of small firms be fully exploited to the national advantage. A number of them already engage in exporting and I am anxious to see more of them becoming export-oriented. These firms at present account for a substantial part of employment in manufacturing industry and the possibilities for future job-creation will be clear".[1]

28.15 It is clear that the relief for small companies has been seen primarily as an incentive for the manufacturing sector. We will consider the tax treatment of manufacturing companies in a later report. At this stage, we are concerned with whether or not relief for small companies should be of general application.

28.16 In coming to a decision on this issue we are in agreement with the approach taken in the 1972 White Paper on Company Taxation in Ireland which stated:

> "In the taxation of small companies the objective should be to put them as nearly as possible in the same tax position as their competitors; in other words, to devise a system that will charge the same tax on a trader whether he carries on his business on his own or whether he incorporates it. The level of taxation on small companies must therefore be considered in conjunction with the tax treatment accorded to businesses with similar profits operated by individuals or partnerships".[2]

28.17 Our earlier proposals regarding the introduction of a full imputation system of corporation tax and for the selection of the rate of corporation tax are designed to achieve greater neutrality between all companies and other business organisations. In addition, we note that directors' remuneration is allowed in full as a deduction in computing company profits. We do not consider that further relief for small companies is justified on grounds of neutrality. If the furthering of economic growth is thought to justify tax concessions or other financial incentives to small enterprises, we believe that they should be confined to specific sectors and offered irrespective of the form of business organisation.

The Taxation of Closely-held Companies

28.18 The term closely-held company is applied, broadly speaking, to a private company where five or fewer individuals control more than 50 per

[1] Dáil Debates 1 February, 1978.
[2] *Company Taxation in Ireland*. November, 1972 Prl. 2628 paragraph 345.

cent of the ordinary shares. In the case of a closely-held family company, the policy of the board may decide the extent to which trading surpluses are withdrawn in the form of remuneration of directors or left as profits in the hands of the company.

28.19 It has long been recognised that, where close companies can obtain a tax advantage by retaining their profits rather than by paying them out in the form of remuneration or dividends, there will be a tendency for such companies not to make distributions. Anti-avoidance provisions in this area were enacted as long ago as 1922. The provisions acknowledged that it was reasonable for companies with plans for expansion, or companies likely to require capital for an emergency situation, to retain ample profits for these purposes. The situation was viewed differently, however, where large undistributed profits might lie idle in the company's hands or be put into portfolio investments totally unconnected with the business of the company. In that case, the Revenue Commissioners were empowered to charge the company to sur-tax in an amount equivalent to what would be payable by the proprietors if the profits withheld were distributed to them in dividends.

28.20 In order to counter the advantages of forming investment companies purely for reasons of tax avoidance and retaining the profits in these companies, the Corporation Tax Act, 1976 provided for a surcharge of 20 per cent on the after-tax, undistributed investment or rental income of close companies. The surcharge provisions are described in paragraphs 25.15 and 25.16.

28.21 We received a number of submissions which suggested that the surcharge was unfair in that it discriminated against genuine firms providing professional services, which must retain profits to provide working capital.

28.22 Another submission argued that

> "the private limited company has become the lynch-pin of many tax avoidance schemes and, in this connection, it will be noted that 90 per cent of all companies formed are such private companies.".

This submission then proposed, that for tax purposes only, the "corporate veil" be stripped away in these companies and the Revenue Commissioners empowered to look through to the participators in the company, as was done for partnerships in 1965.

28.23 Under our proposals for a single rate of tax on all incomes, the problem of tax avoidance through the use of close companies does not arise. During the transition to a single rate of tax, we favour taxing close companies on a partnership basis. In these circumstances, we recommend

the abolition of the surcharge on the undistributed income of close companies.

Recommendations

28.24 We make the following recommendations:

1. The rate of corporation tax should be the single rate of personal income tax recommended in Chapter 17.
2. In the case of companies liable to corporation tax, a minimum payment of corporation tax should be made. This payment should be equal to the amount of the tax credit on distributions by the company.
3. The amount of the tax credit on a distribution should be equivalent to tax at the standard rate of income tax on the aggregate of the net distribution and the tax credit.
4. The minimum payment of corporation tax in respect of distributions should be credited against the corporation tax liability of the company.
5. The due dates for payment of tax by companies should be the same as for self-employed individuals.
6. The acceleration in the collection of tax from companies should be achieved by advancing the dates of payment by a maximum of three months per year.
7. The recommendations in relation to the period of grace and payment of interest on overdue tax which we have recommended in the case of self-employed persons should also apply to companies.
8. The special rate of corporation tax which applies to small companies should be abolished.
9. During the transition to a single rate of income tax, close companies should be taxed on the same basis as partnerships. Accordingly, the surcharge on the undistributed income of close companies should be abolished.

CHAPTER 29

INTERNATIONAL ASPECTS OF COMPANY TAXATION

Introduction

29.1 We now examine the international implications of adopting a full imputation system of corporation tax which we consider is desirable. We conclude that this would be consistent with Ireland's international commitments and would have a beneficial effect on foreign investment in Ireland.

International Requirements

29.2 The Irish system of company taxation must comply with two basic requirements. It should

(i) facilitate the flow of foreign investment into Ireland for development purposes, and

(ii) be compatible with our EEC obligations.

Double Taxation

29.3 A multinational enterprise is normally a company resident in one country and operating in another country either through

(i) a branch, or

(ii) a subsidiary company resident in the other country.

In normal circumstances, this will give rise to double taxation in respect of the profits which will be chargeable to tax where the profits are generated (origin country) and again in the country of residence of the enterprise to which the profits flow (destination country).

29.4 In the case of a branch operation, the profits will be charged to company taxation in the origin country and, if the destination country has the usual system of assessing residents on their world-wide income, the profits will also be charged to company taxation in the destination country. In the absence of double taxation arrangements between the destination

country and the origin country, the only relief from double taxation normally available would be a deduction in computing the profits for tax purposes in the destination country of the tax paid in the origin country.

29.5 If the activity is carried on through a subsidiary company, direct liability to company taxation on the profits of the activity will arise in the origin country. Liability to company taxation will arise in the destination country only when those profits are distributed by way of dividends paid by the subsidiary to the parent company. In the absence of double taxation arrangements between the destination country and the origin country, the only relief from double taxation normally available in the destination country will be by way of a deduction for any withholding tax which the origin country may impose on the dividends. In other words, the parent company would be charged on the gross dividend net of withholding tax. No relief would be available in respect of the origin country tax paid on the profits out of which the dividends were paid.

Elimination of Double Taxation

29.6 There are two methods of eliminating double taxation:

(i) the *exemption system*, under which income will be taxed in only one country and exempted from tax in the other country, or

(ii) the *credit system*, under which tax paid in one country (the country of source, normally the origin country) is allowed as a credit against the tax liability on the same income in the other country.

29.7 Apart from some specific items of income in respect of which the exemption system may apply (e.g. interest in some cases, Government remuneration, pensions, etc.), Ireland's double taxation arrangements generally provide for the elimination of double taxation by the credit system.

29.8 The effect of Irish double taxation arrangements on the taxation of the profits of a multinational enterprise is as follows: business profits earned by an Irish enterprise through a permanent establishment in another country are normally charged to tax in that country and double taxation is avoided by the granting of a credit for the foreign tax against the Irish tax charged on those profits.

29.9 In the converse case of profits earned through a permanent establishment in Ireland by an enterprise of another country, double taxation is avoided either by

(i) that other country allowing credit for the Irish tax against its own tax on the profits, or

(ii) that other country exempting the profits from its own tax.

Subsidiary Company Operation

29.10 The profits of a subsidiary company of an Irish parent company flow to the parent company in the form of dividends paid by the subsidiary. Where a country, in which the subsidiary is resident, imposes a withholding tax on dividends, the double taxation arrangements will normally provide for a reduced rate of withholding tax (usually 5 per cent in parent/subsidiary cases)[1]. The dividends will be chargeable to Irish corporation tax but credit will be given for any withholding tax and, in the case of a subsidiary's dividends, for the underlying tax on the profits out of which the dividends were paid.

29.11 In the case of dividends paid by an Irish subsidiary to its parent company in a country with which Ireland has a double taxation agreement, relief from double taxation is granted either by way of credit for the underlying Irish tax on the profits or by exemption from tax of the dividends in the hands of the parent company.

Irish Dividends under the Partial Imputation System

29.12 Under the Corporation Tax Act, 1976, dividends paid by an Irish company carry a tax credit (30/70ths in the normal case with special arrangements for companies qualifying for export sales relief or the 10 per cent rate of tax). A non-resident recipient is not entitled to the tax credit. In double taxation arrangements entered into since that Act (i.e. those with the United Kingdom), provision has been made whereby a resident of the partner country, other than a direct investor[2], beneficially entitled to a dividend from an Irish company, is entitled to payment of the tax credit subject to a liability to Irish tax of 15 per cent of the aggregate of the dividend plus the tax credit. This means that a resident of the United Kingdom (other than a direct investor) can claim payment of the tax credit in respect of Irish dividends subject to a restriction of the 15 per cent Irish tax liability.

29.13 A direct investor from the United Kingdom is not entitled to the tax credit in respect of Irish dividends but the Irish tax on the profits out of which the dividends are paid is allowed as a credit against the United Kingdom tax chargeable on the dividends.

29.14 As the United Kingdom system of company taxation is also a partial imputation one, similar provisions apply in the converse case in relation to the tax credit in respect of United Kingdom dividends.

---

[1]The usual criterion for the parent/subsidiary relationship is that the company holds at least 10 per cent of the voting power of the company paying the dividends.

[2]A "direct investor" is a company which controls 10 per cent or more of the voting power in the company paying the dividend.

Double Taxation Arrangements and Ireland's Tax Incentive Schemes

29.15 Where dividends are paid out of profits which have been relieved from Irish tax under Irish tax incentive schemes, the position under Ireland's double taxation arrangements with other countries varies. In some cases, specific provision is made in the arrangements whereby the partner country allows credit for the Irish tax which would have been paid but for the special relief, i.e. "matching-credit" is allowed. The benefit of the Irish incentive is therefore passed on to the foreign investor. In some other cases, the partner country's domestic law, which, in certain circumstances, provides for an effective exemption from tax in respect of dividends from a subsidiary company, is applied by provisions in the arrangements to dividends from subsidiaries in Ireland. In these cases also the foreign investor retains the benefit of the Irish tax relief. In other cases, Irish dividends received by shareholders in the partner country or profits accruing to an Irish branch of the foreign enterprise (unless exempt under the domestic law of that country) are fully charged to tax in the partner country and the benefit of any Irish tax incentive is frustrated.

Change to Full Imputation System

29.16 If the Irish policy of paying the tax credit in respect of dividends only to investors other than direct investors (i.e. portfolio investors) is maintained, a change to a full imputation system of corporation tax would not affect direct investment. An increase in the rate of imputation on Irish dividends would result in an increase of the payments to be made by the Irish Revenue Commissioners to United Kingdom portfolio investors at existing rates of corporation tax. To the extent that there would be a loss of Irish revenue, it might encourage more portfolio investment from the United Kingdom, particularly in the case of large institutional investors who are exempt from United Kingdom tax, i.e. charities and pension funds. However, any increase in repayments arising from a change to a full imputation system is likely to be offset by a reduction in tax credits on dividends arising from the reduction in the rate of corporation tax to the single rate of income tax.

29.17 We believe that the general system of corporation tax which we recommend would have a beneficial effect on foreign investment in Ireland.

EEC Obligations

29.18 In August, 1975, the EEC Commission submitted to the Council of Ministers proposals[3] in the form of a draft directive for the harmonisation

---

[3]*Proposal for a Council Directive Concerning the Harmonisation of Company Taxation and Withholding Taxes on Dividends*, August 1975.

of corporate tax systems within the EEC. This draft directive provides for the introduction in all member States of a common partial imputation system, having a single rate of corporation tax in the range 45 to 55 per cent and a tax credit of between 45 and 55 per cent of the amount of corporation tax. It also provides for a common withholding tax on dividends at the rate of 25 per cent.

29.19 The closer alignment of company tax burdens in the EEC is designed to ensure that companies in different Member States can enjoy conditions of fair competition and that capital movements are not prompted by tax considerations.

29.20 There are a wide variety of systems of company taxation in operation in EEC countries as shown in Table 34.

TABLE 34

System of Company Taxation in EEC Countries

Country	System	Effective Rate of Credit as per cent of Corporation Tax
Belgium	Partial imputation	49.8
Denmark	Partial imputation	25.5
Federal Republic of Germany	Two-Rate	100.0
France	Partial imputation	50.0
Greece	Two-Rate	100.0
Ireland	Partial imputation	52.4
Italy	Partial imputation	58.6
Luxembourg	Classical	Nil
Netherlands	Classical	Nil
United Kingdom	Partial imputation	39.6

Source: Report on the Scope for Convergence of the Systems in the Community, Bulletin of the European Communities' Supplement 1/80 Table 12. Situation at 31 December, 1979

29.21 Little progress has been made towards achieving harmonisation of systems of company taxation. The European Parliament has still not delivered a formal opinion on the draft directive as required by the Treaty of Rome. Their interim report of 2 May, 1979 calls for the deferment of common rate bands and for priority to be given to harmonising the tax base. The EEC Commission disagrees with this approach since it would leave untouched the distortions in capital movements which result from the fact that systems are not in harmony.

29.22 As progress towards the harmonisation of company tax systems in the EEC has been very slow, we do not regard the proposed directive in its present form as a significant constraint on our recommendations.

CHAPTER 30

ASPECTS OF THE TAXATION OF FINANCIAL INSTITUTIONS

Introduction

30.1 In this chapter we deal with certain aspects of the taxation arrangements which should apply to income which arises in the first place to financial institutions. These concern tax-related lending, the imposition of special levies on banks and the taxation of banks and building societies. We believe that the income of financial institutions should be subject to the same treatment for tax purposes as other income. We leave the taxation of other financial institutions to a later report. However, *prima facie*, we see no case for special levies on such institutions, such as the proposed levy on insurance companies.

Background

30.2 In his address at our first meeting, the Minister for Finance asked us to examine the taxation arrangements applying to financial institutions at an early date. We considered presenting an interim report on this matter but decided that it was neither possible nor desirable to do so without first considering the system of direct taxation which we thought should apply generally. The Minister was especially concerned about the impact of tax-related lending on the amount of tax remitted by the banks to the Exchequer. Special levies on banks were imposed in July, 1981 and March, 1982.

30.3 A levy on insurance companies was also announced in March, 1982. It is proposed that this levy be at a rate equivalent to 1 per cent of the premium income of insurance companies from domestic business, excluding medical insurance. The levy will apply with effect from 1 August, 1982.

30.4 In his budget statement on 25 March, 1982, the Minister for Finance said:

> "I see these levies as a temporary arrangement and I will be considering in due course proposals for the introduction of a new permanent

system of taxation of financial institutions when the recommendations of the Commission on Taxation become available".[1]

30.5 In general, we consider that the proposals we have made for the determination of business income should apply to financial institutions as to other forms of business. A number of technical issues in relation to the taxation of financial institutions have been raised with us and we will deal with these in a later report. In this chapter we deal with the question of tax-related lending, the imposition of special levies on banks and the taxation of building societies. We have also felt it necessary to take into account the different regulatory arrangements which apply to financial institutions. These are relevant to the taxation of financial institutions since if the regulatory arrangements are not standardised, the elimination of distortions caused by taxation will not lead to efficiency in financial markets.

Banks

30.6 At present, banks are liable to corporation tax on their profits at a rate of 45 per cent, which is the same as the rate paid by other incorporated businesses which are not engaged in manufacturing. It has been proposed to increase this to 50 per cent with effect from 1 January, 1982. In July, 1981, a special levy of £5 million was imposed on the banking system. This was distributed between banks according to the relative size of the total of their current and deposit accounts held within the State in excess of £15 million. A further levy of £20 million was imposed in March, 1982. These levies in their application to individual banks had no regard to the profitability or otherwise of the individual bank or whether or not the bank engaged in tax-related lending. They were borne equally by banks incurring losses and those paying the full rate of tax on their profits and did not generally qualify as a credit against tax payable in other countries.

30.7 A number of issues must be considered in order to arrive at a proper conclusion concerning the taxation of bank profits:

(i) The role of the Central Bank;

(ii) The incidence of bank taxation;

(iii) Liquidity ratios as a form of taxation;

(iv) Special bank levies, and

(v) Tax-related lending.

---

[1]Dáil Debates, 25 March, 1982 Vol. 333 No. 4 Col. 606.

Role of the Central Bank

30.8 The Central Bank Act, 1971 gave responsibility for the licensing and supervision of banks to the Central Bank. In their submission to us, the Central Bank stated that in exercising their role, the Bank's primary concern is to ensure that licensed banks continue to be safe repositories of the savings of the public. The adequate capitalisation of banks is a factor to which the Bank attaches great importance in this regard. In the case of the main associated bank groups the requirement adopted by the Bank is that the capital employed by the licensed banks should not be less than 6.5 per cent of gross assets, which comprise fixed assets, investments, advances and cash and short-term funds.

30.9 In general, the gross assets of banks must grow broadly in line with national output expressed in money terms. It follows that capital employed must grow in proportion if the ratio adopted by the Central Bank is to be maintained. As retained profit is a principal source of such capital growth, the Central Bank has established criteria relating to pre-tax profit and the appropriate minimum level of retained profit, given the level of taxation and the necessity to remunerate share capital. In this connection, the Central Bank has recognised that the rate of dividend paid by the banks should be reasonable in relation to prevailing commercial standards and sufficient to ensure a market rating that would facilitate the banks in raising additional capital resources when necessary. On this basis, the Central Bank has devised a formula to yield an objective indicator of the minimum rate of profitability required to maintain a given capital ratio. It does not identify an acceptable maximum level of profitability. The formula incorporates factors relating to taxation, dividends and asset growth including allowance for the influence of inflation.

The Incidence of Bank Taxation

30.10 It is clear that any tax levied on banks cannot be borne by banks as an institution but must come out of the pocket of some individual whether shareholder, customer, employee or supplier. The Minister for Finance stated that the levy imposed in July, 1981 could not be recouped in the form of higher charges. Given that bank profits have been at or below the minimum level set by the Central Bank to maintain capital adequacy, it follows that if the Central Bank allows banks to increase their prices to compensate for extra taxation, then the burden of taxation will fall almost exclusively on bank customers. This will be in the form of lower interest rates for depositors, higher bank charges or, most likely, higher interest rates for borrowers. These additional costs may be further shifted to the general public in the form of price rises or to the taxpayer in so far as the income of depositors is charged to tax or deductions are allowed for the higher interest charges to other taxpayers.

30.11 Alternatively, if the Central Bank does not allow bank charges to be raised, the burden will fall on bank shareholders, suppliers and employees, to the extent that efficiency is not increased. If the capital ratio falls to an inadequate level, depositors funds will be put at risk.

30.12 The subject of incidence is one of particular difficulty. However, it is clear that the effective incidence of bank taxation is far wider than is generally recognised.

Liquidity Ratios as a Form of Taxation

30.13 Certain Irish financial institutions are required to hold primary and secondary liquidity. Primary liquidity consists essentially of deposits with the Central Bank, while secondary liquidity consists mainly of holdings of Irish Government securities.

30.14 The liquidity ratios at present in force are shown in Table 35.

TABLE 35

Liquidity Ratios

Institution	Primary Ratio	Secondary Ratio
	%	%
Associated Banks	10	25
Non-Associated Banks	10	13-15
Agricultural Credit Corporation	None	None
Industrial Credit Company	None	None
Building Societies	£0.5 m each	None

The associated banks must hold a total of 35 per cent of their resources in the form of deposits with the Central Bank or Government securities. For the non-associated banks the figure varies — 23 per cent for some and 25 per cent for others. The State-owned financial institutions have no liquidity ratios imposed by the Central Bank. Building societies must make a statutory deposit of £0.5 million with the Central Bank. Since this does not vary with the scale of their operations, it is in the nature of an establishment charge rather than a liquidity requirement. In practice, the Industrial Credit Company, the Agricultural Credit Corporation and the building societies do hold liquid assets for ordinary business reasons. In the case of the building societies, they have been holding over 20 per cent of their resources in liquid instruments.

30.15 The rate of interest paid on primary liquidity is related, through a Central Bank formula, to yields on Government securities. To the extent that yields on holdings of primary or secondary liquidity are below yields available in the marketplace, a bank with a high liquidity ratio is placed at

a competitive disadvantage *vis-à-vis* a bank with a lower ratio. This is a potential distortionary factor in financial markets unless all competing banks face liquidity ratios which are calculated in the same way by reference to the maturity pattern of their liabilities. To the extent that the return on compulsory liquidity holdings is lower than that obtainable elsewhere, the shortfall constitutes a form of taxation according to our definition. We defined taxation in Chapter 1 as a compulsory payment to the State where the benefits are not related to the amount paid.

30.16 Primary liquidity ratios may be deemed to serve a prudential function in regulating financial institutions which experience cash drains. However, other regulatory devices are available. For example, Central Bank accommodation at penal rates would give banks an incentive to hold adequate liquid balances. Secondary liquidity ratios are not common in other developed countries and in Ireland their main purpose is to provide funding for the Exchequer. To the extent that captive lenders are forced to lend to the Exchequer at artificially low rates, this is a form of hidden taxation levied on banks. On the basis of our earlier analysis, such a hidden tax is most likely to be passed on to bank borrowers.

30.17 It is desirable that all similar financial institutions which compete as either borrowers or lenders should have liquidity ratios which are calculated on the same basis. This could be achieved by

(i) abolishing the secondary liquidity ratios which are not essential for monetary policy purposes, and

(ii) applying a uniform primary liquidity ratio to all financial institutions. There should be no element of hidden taxation in the operation of this ratio. However, to the extent that this does arise, the profits of the financial institution should be deemed to include the element of hidden taxation and that element allowed as a credit against any tax liability on the profits so increased. This treatment should not apply to special deposits at penal rates for breach of credit guidelines laid down by the Central Bank.

30.18 At present, the banking system is required to hold about £600 million in primary liquidity. The rate paid on these deposits is about 3 per cent below market rates. This implies hidden taxation of £18 million since the surpluses of the Central Bank are transferred to the Exchequer. If market rates applied, the profits of the banking system would be £18 million higher and tax would be paid on this at the normal rate.

Special Bank Levies

30.19 We described in paragraph 30.6 the special levies imposed on banks in July, 1981 and again in March, 1982. These levies were the result of calls

from many sources for special taxation of financial institutions which were based on a general belief that the institutions were paying insufficient tax in relation to their income.

30.20 One argument for special taxation arrangements for bank profits could be that such profits are excessively large. Such an argument would imply that the Central Bank has not been able to maintain profits within the guidelines set by it. In fact, bank profits have been at the bottom or below the recommended range. However, even if bank profits were excessive, this situation should be tackled not by special taxation measures but by Central Bank action to reduce the prices charged to consumers of bank services or to increase deposit rates.

30.21 Although the rate of taxation of corporation profits was 45 per cent on their historical cost profits for the year ended 31 March, 1981, the actual taxation charge in the banks' accounts for that financial year is much less than this, about 27 per cent, and the rate of taxation paid is lower still, about 18 per cent. The difference between the taxation charge of 27 per cent and the nominal rate of corporation tax of 45 per cent is due mainly to the effects of Section 84 loans (dealt with below under the heading of tax-related lending) on pre-tax profits. The difference between taxation paid and taxation charged is accounted for by the deferral of taxation which arises mainly from the banks' involvement in leasing.

Tax-related Lending

30.22 Apart from the usual forms of finance provided by banks, such as overdrafts and term loans, there are five types of finance which banks provide which are designed to obtain benefits from certain provisions of tax law. These benefits are in large measure passed on to customers. The types of finance in question are

(i) leasing,

(ii) preference share financing,

(iii) Section 84 type loans,

(iv) house-purchase loans and

(v) loans to certain farmers.

These are described in Appendix 24.

30.23 To come to a conclusion on the issue of tax-related financing two questions must be answered. Firstly, are all the benefits passed on by the banks to the borrowers? If this is the case, then these tax-based lending schemes are methods through which the Exchequer subsidises, *via* the banking system, projects undertaken by various sectors. The question then arises whether or not this is the most efficient way to operate a subsidy scheme.

30.24 In this report we content ourselves with dealing with the first question, since this is the only one of relevance to the taxation of financial institutions. To the extent that banks pass on the reduction in their tax to their borrowers, we are satisfied that no additional special taxation arrangements should apply to financial institutions on that account. The second question will be dealt with in a later report in which we will be concerned with the level of incentives that should be provided, whether these should be provided through the tax system and, if so, in what form.

30.25 We received the following evidence on the question of the ultimate incidence of the benefit of tax foregone in tax-related lending operations.

30.26 The Irish Banks Standing Committee informed us that

> "Competition amongst both the Associated and non-Associated Banks to provide services, including tax-related financing, ensures that virtually the whole tax benefit accrues to the companies using them . . . Tax-related financing does not have a material effect on the after-tax profits of the Banks. It does, however, reduce the level of pre-tax profits, it also reduces or defers tax".

30.27 The Central Bank of Ireland concluded that

> "the abolition of the various tax-related schemes mentioned would be unlikely to affect significantly the maintenance of capital adequacy by the banks; most of the tax benefit to the banks is passed on to customers using these methods of financing in the form of low interest rates and rental charges and abolition would increase these rates to normal levels, as well as increasing the banks' tax liability".

30.28 The Industrial Development Authority advised us that

> "The present mechanisms of providing low-cost finance through leasing (used for fixed asset financing) and Section 84 loans (used mainly for working capital needs) are both essential to industrial promotion given high Irish interest rates and the absence of alternative low cost financing methods. In an analysis of IDA controlled leasing it has been shown that the industrial promoter gets virtually all of the tax saved by the banks. The introduction of controls on Section 84 loans similar to those that exist in the case of grant-aided leasing would ensure that the tax saved was passed on to the companies and that the loans were used for designated purposes. Companies benefiting from the 10 per cent manufacturing tax relief generally will not be able to fund their working capital requirements by Section 84 loans and alternative sources of low cost finance will be needed to meet their *bona fide* needs".

30.29 In considering this issue we had the benefit of a report which we commissioned from independent consultants. To determine whether the banks pass on the full benefits of the lower tax bill to the borrowers, it is necessary to compare the net of tax internal rate of return[2] of the bank on different forms of lending. These are

(i) a leasing agreement with a 35 per cent grant,

(ii) a Section 84 loan and

(iii) an ordinary term loan.

The size and cost of finance in each case is the same for the bank. However, the stream of loan repayments and tax payments differs in each case.

30.30 The example taken was that of a company purchasing an asset costing £1,000 with an IDA grant of 35 per cent. Typical terms for such a project early in 1982 were:

(i) *Leasing:* £30 per quarter (payable in advance) for five years after which there would be further payments of £6.50 per annum for another five years.

(ii) *Section 84:* 55 per cent of the Dublin interbank offered rate plus 3 per cent. At an interbank rate of 18.75 per cent, this would amount to 13.31 per cent.

(iii) *Term Loan:* Two per cent above the Dublin interbank rate.

30.31 The internal rates of return to the banks on these transactions are shown in Table 36.

TABLE 36

Internal Rates of Return to Banks on Certain Lending Transactions

	%
Leasing*	15.38
Section 84	13.31
Term Loan	12.68

*A feature of a leasing transaction is that the account goes into credit before the end of the lease as funds are set aside to meet future tax liabilities in relation to the transaction. The rate of return quoted assumes that the rate of return is independent of whether the amount is in credit or debit.

One reason for the higher internal rate of return on leasing transactions is the banks' greater exposure to risk. In our example, while the bank lent £650, it is liable to repay an additional £350 grant to the IDA if the company

[2]The internal rate of return is the rate of return on an investment which makes the discounted value of the cash flow equal to the initial investment.

is unsuccessful. The second reason for a higher rate of return on leasing is that leasing is generally provided at a fixed rate and banks build in a factor to compensate for the risk of adverse movements in the rate of interest. The rates of return quoted can vary with assumptions about the timing of tax payments by banks, particularly in the case of leasing. If account is taken only of the payments of the first five years, the rate of return on leasing is reduced to around 14.5 per cent.

Conclusion

30.32 On this basis, the banks pass on almost all of the tax savings arising from tax-related lending operations to borrowers. Therefore, there would appear to be no case for special taxation arrangements for financial institutions on the grounds that their tax payments appear artificially low in relation to their profits. There is no case for special levies on these grounds.

Withholding Tax on Distributions

30.33 Our recommendation in Chapter 28 in favour of a withholding tax on distributions made by companies would, if implemented, effectively negative the benefit of Section 84 loans and preference share financing, except in the case of companies qualifying for export sales relief. We consider that distributions out of profits relieved from tax by virtue of export sales relief should continue to be free of tax. Companies making distributions out of other profits would be required to deduct tax at a rate equivalent to the single rate of tax on the gross distribution. The distribution would carry no further tax liability in the hands of the recipient company. The tax deducted would be subsumed into any tax liability on the profits of the company making the distribution. The question would then arise whether or not the tax credit should be refundable in a situation in which the paying company had no liability to tax by virtue of the operation of incentive reliefs. This is a question we leave open for consideration in a later report.

30.34 We recognise that such a change if introduced immediately would give rise to difficulties for financial institutions who have incurred contractual obligations on the basis of existing arrangements. For that reason, we recommend that any withholding tax should not be levied on distributions made under existing arrangements. The effect of this change would be that there would be no tax advantage from entering into Section 84 loan arrangements or preference share financing schemes except in the case of companies qualifying for export sales relief.

Building Societies

30.35 Building societies are subject to special taxation arrangements. The

profits of building societies are charged at a special rate of corporation tax, which applies to companies or institutions which are precluded from distributing their profits. Building societies are subject to more favourable liquidity requirements than competing institutions as we noted in paragraph 30.14. Special arrangements also apply for the taxation of interest earned by building society depositors and these are described in paragraph 11.34.

30.36 We recommend that building societies should be subject to the same taxation requirements as other institutions with which they must compete for funds, and to liquidity ratios which are calculated on the same basis. To achieve this we recommend that they be liable to tax at the single rate on their profits. We also recommend that responsibility for the regulation of building societies be transferred to the Central Bank.

Recommendations

30.37 We make the following recommendations:

1. The income of all banks should be charged to tax in the normal way, that is, at the single rate of tax.
2. As far as the taxation of financial institutions is concerned, there is no need to limit the use of tax-related lending. We will deal with the question of whether or not tax-related lending is an efficient means of providing an incentive to industry in a later report.
3. The withholding tax recommended in Chapter 28 should not apply to distributions under tax-related lending agreements entered into under existing arrangements.
4. No further special levies should be imposed on banks.[3]
5. Building societies should be charged to tax on their profits at the single rate of tax recommended in Chapter 17.

[3]Footnote by Mr Donal Nevin. I consider this recommendation to be gratuitous in the light of the fact that the levy has been stated to be temporary and was implemented by successive Governments at a time of acute fiscal difficulties.

CHAPTER 31

INCOME FROM SELF-EMPLOYMENT

Introduction

31.1 There is widespread belief that income from self-employment charged to tax under Schedule D is treated more leniently than income from employment charged under Schedule E. The belief that assessment under Schedule D is more advantageous arises because

(i) of the rule allowing a deduction for expenses, and

(ii) the basis of assessment and arrangements for payment of tax are different from the corresponding arrangements under Schedule E.

The question of whether evasion of tax is easier and more widespread under Schedule D is raised frequently. We will deal with the general question of evasion in a later report. Here we are concerned solely with questions of structure.

Definition

31.2 Income from self-employment concerns income (net profit) from a business, trade, farm, profession or vocation. We received representations from certain groups, who are at present regarded as employees and charged to tax under Schedule E, that they should be charged under Schedule D. The proposals in this report are designed to equalise the treatment of income under the two Schedules. Because of the administrative advantages of collecting tax under Schedule E, we consider that all persons at present chargeable under Schedule E should continue to be so chargeable.

Company and Personal Taxation

31.3 The relative tax treatment of unincorporated business entities and incorporated entities was raised in a submission by the Consultative Committee of Accountancy Bodies — Ireland (CCAB-I), which suggested that the present system was inequitable for the following reasons:

(i) Business entities are subject to different rates of taxation, depending upon whether they are incorporated or unincorporated.

(ii) Unincorporated business entities having similar taxable income are subject to different rates of taxation, depending upon the taxable status of their proprietors.

(iii) Individual proprietors have a substantially different method of determining their tax liabilities, depending upon whether their income is in the form of a dividend from a company or drawings (cash and goods) from an unincorporated entity.

(iv) Undistributed profits retained within a company are taxed at corporation tax rates, whereas profits retained within an unincorporated business are taxed in the same way as those withdrawn — at the effective personal tax rate of the proprietor.

The submission goes on to argue that

> "There is clearly a need to harmonise the taxation of business entities whether they are owned by companies or individuals. In logic and in equity the same total tax should be imposed on the same profits of similar businesses, irrespective of whether they are generated in an incorporated or unincorporated entity. Similarly, equal personal income should bear an equivalent amount of tax (given similar circumstances) in the individual's hands irrespective of its source. These objectives could be achieved by eliminating the present fully integrated structure of taxation in relation to profits chargeable under Schedule D of the Income Tax Act, 1967 and treating them similarly to the way in which company profits are taxed under the Corporation Tax Act, 1976. In other words the business entity would not be regarded as being synonymous with its owners, but taxable as a separate economic unit".

31.4 We cannot accept that an equity problem arises between entities. Equity is a principle which enables the relative tax burden of individuals to be determined. However, it is desirable, for reasons of efficiency, that the tax system should be neutral between different types of business organisations. In our consideration of the general system of taxation of company income, we attempt to do this by proposing certain changes which would bring the treatment of companies into line with that of unincorporated entities. In order to achieve this desired neutrality of treatment, two elements in the taxation system are essential. Firstly, there must be full imputation of tax borne at the company level when distributions are made to shareholders. Secondly, all income must be charged at a single rate of tax.

Basis of Assessment

31.5 Employees chargeable to tax under Schedule E are liable to tax for the current year on the basis of the income actually earned in the year of assessment. Self-employed persons engaged in a trade or profession are

normally chargeable to tax for the current year of assessment on the basis of the profits of the preceding year. This is modified, however, in practice so that the profits of an accounting period of twelve months, ending in the preceding year of assessment, are taken to be those of the preceding year. Thus, the profits of the twelve-month accounting period ending between 6 April, 1981 and 5 April, 1982 inclusive form the basis of assessment for the income tax year 1982/83.

31.6 There are special provisions relating to the first three and final three years of assessment in which a trade or profession is carried on. For the first year, the profits chargeable are those from the date of commencement until the following 5 April. For the second year, the profits assessable are those of the first twelve months' trading. If the actual profits of the second year of assessment are lower than those of the first twelve months of trading, the taxpayer may claim (within a prescribed time) to be assessed on the lower amount. For the third year, as for subsequent years, the profits assessable are those of an accounting period of twelve months ending in the preceding year. The taxpayer may claim (within a prescribed time) for a reduction in the assessment for the third year equal to the excess (if any) of the aggregate assessment for the second and third years over the total actual profits of those two years.

31.7 In the case of a permanent cessation, the assessments for the prepenultimate and penultimate years will have each been based on the profits of an accounting period of twelve months ending in the preceding year. Where the aggregate of the actual profits for these two years exceeds the aggregate of the profits originally assessed for those years, the inspector of taxes will revise the assessments for each of the two years to the actual profits of those years. For the final year, the assessment is based on the profits from 6 April in that year to the date of cessation.

31. 8 It will be apparent that some profits form the basis of assessment for more than one period, while others do not form the basis of any assessment. We received numerous representations that the present system creates an inequity between persons charged to tax under Schedule E and Schedule D, in favour of the latter.

31.9 Assessment on the basis of the income of the preceding year rather than the current year confers a significant advantage in periods of rising money income. This is shown by the following example. It is assumed that an individual begins employment on 1 January. The total income in the first year is £5,000 and is assumed to increase by 10 per cent per year. The amounts chargeable to tax under Schedules D and E are shown in Table 37.

The income assessed under Schedule D is 10.5 per cent less than that under

TABLE 37

Example of Assessments under Schedules D and E

Year	Schedule E	Schedule D
	£	£
1	1,250	1,250
2	5,125	5,000
3	5,637	5,000
4	6,201	5,500
5	6,821	6,050
6	7,503	6,655
7	8,253	7,320
8	9,078	8,052
9	9,986	8,857
10	10,985	9,743
	70,839	63,427

Schedule E over a ten year period, even though the earnings profiles are identical.

31.10 It should be noted that self-employed persons are usually taxed on the basis of income accrued or earned, whether or not it is actually received. This is in contrast to employees who generally pay tax on their actual receipts.

31.11 To remove the inequity resulting from the use of different bases of assessment for income arising from different sources, we recommend that all income should be charged on the basis of income arising in the current fiscal year. Where accounts are not made up on the basis of the fiscal year, apportionments will be required, pending the introduction of the single rate of tax. The adoption of a current basis of assessment requires the institution of new arrangements for payment of tax by self-employed persons which we discuss in the following paragraphs. We also recommend that, concurrent with the adoption of a current basis of assessment, the additional allowances for Schedule E taxpayers should be abolished. These proposals would also alleviate the hardship imposed by the present system on self-employed persons with falling incomes who may not have made adequate provision for the payment of tax.

Transitional Provisions

31.12 When PAYE was introduced on 6 October, 1960, the second instalment of tax for 1959/60 which was due on 1 January, 1961 was waived. This was because its collection would have required employees to pay twelve months tax in a six month period. When certain employees in

the public sector were brought within the scope of PAYE in 1976, they were granted a remission of half the tax payable for 1975/76 spread over three years. This was granted even though a cash flow problem did not generally arise, since the dates of payment of tax for 1974/75 and 1975/76 did not overlap.

31.13 The extension of a current year basis of assessment to all other taxpayers would undoubtedly give rise to calls for a similar concession. During the Committee Stage Debates on the Finance Bill, 1976 when a proposal to advance the dates of payment of Schedule D tax by three months was being debated, there were calls for a remission of Schedule D tax to compensate for the adverse effects on cash flow of the proposal. These calls were rejected by the Minister for Finance who stated:

> "We are not proposing to do as so many other countries do, to require Schedule D taxpayers to pay instalments of tax on current income pending final assessment . . . if that is ever proposed here, then that would be the appropriate time to give what the opposition are now looking for: a remission of tax to compensate for this change".[1]

31.14 A case can be made for a concession to self-employed persons on the same grounds as those put forward by public servants in 1976. We make no recommendation on this matter. However, as was the case in 1960 and in 1976, a change from a preceding year basis to a current year basis would mean that there would be at least one accounting period which would not form the basis period for any year's income tax. Steps would need to be taken both to prevent avoidance and to afford relief for capital expenditure and losses incurred in an accounting period which would not form the basis for any assessment.

Deduction of Expenses

31.15 We noted in Chapter 10 that, in the case of Schedule E taxpayers, the income to be charged to tax is the actual receipts in the year *less* only those expenses which are incurred "wholly, exclusively and necessarily" in the performance of the duties of the office or employment. On the other hand, all expenses "wholly and exclusively" incurred for the purposes of a trade or profession are allowable under Schedule D. There are two exceptions to this general rule. Firstly, entertainment expenses must also be "necessarily incurred" to qualify as a deduction and in these circumstances only 50 per cent of the amount incurred is allowable. It is proposed that no relief will be allowed in respect of entertainment expenses incurred after

[1] Dáil Debates 12 May, 1976 Official Report Col 1071.

25 March, 1982. Secondly, motor expenses which would otherwise be allowable are reduced by the lower of

(i) one-third of the amount by which the relevant cost of the motor vehicle exceeds £3,500 or

(ii) the proportion which the excess of the cost of the vehicle over £3,500 bears to the cost of the vehicle.

31.16 If the Schedule E rule were applied universally, the only expenses which would be deductible under Schedule D would be those which could be shown to be necessarily expended in producing the incomes of the year in question.

31.17 We asked the Revenue Commissioners for estimates from actual cases of the extent to which the Schedule D rule is more favourable than the Schedule E rule. They replied as follows:

> "It is considered that the addition of 'necessarily' to the Schedule D rule would make little difference in most cases because the only person who could fully assess whether a particular outlay is necessary for the business or not is the business man himself. In the vast majority of cases it would be a futile exercise on the part of Inspectors to challenge expenses actually incurred on the grounds that such expenditure was not necessary to the success of the business. In the circumstances it would not be appropriate to set any figure for the possible tax gain to the Revenue from the application of a Schedule E type rule to a Schedule D case".

31.18 While we accept that in the vast majority of cases it would be a futile exercise on the part of inspectors of taxes to challenge expenses actually incurred on the grounds that such expenditure was not necessary to the success of the business, we consider that the addition of the test of necessity would aid the Revenue Commissioners in establishing equity between taxpayers. We recommend, therefore, that business expenses be deductible only when they are laid out wholly, exclusively and necessarily for the purposes of the trade or profession.

Restriction of Schedule D Expenses

31.19 The limitation on the deductibility of motor expenses, by reference to those applicable to a car costing £3,500 which was fixed in 1976, has been criticised in submissions. These have argued that motor expenses are a legitimate charge against profits for tax purposes. We agree with this view and recommend that motor expenses incurred should be allowed in full against the profits of the business entity.

31.20 In Chapter 12 we recommended certain arrangements for taxing the benefit arising from cars provided by employers, which are available for an employee's private use. We proposed also that the Revenue Commissioners publish a scale of mileage allowances which they would accept as containing no remuneration element. We suggest that consideration be given to restricting business motoring costs incurred by self-employed persons to those scale rates.

31.21 We noted in paragraph 31.15 the special restrictions on entertainment expenses. We have discussed this question with the Chairman of the Revenue Commissioners who told us that

> "these provisions were introduced because of concern that some businesses were seen to entertain on an unduly lavish scale. The restrictions imposed on business entertainment expenses were (a) the imposition of the requirement that they be *necessarily* incurred and (b) the reduction in the amount of allowable expenses to 50 per cent of the amount actually incurred. The first-mentioned restriction did not have much effect in practice and this had led to the second restriction which was introduced in 1980. It is too early to give a considered opinion on the effectiveness of the 50 per cent reduction but it appears from accounts being lodged that there has been some reduction in the amounts now being claimed. In the case of large companies and conscientious taxpayers, the reduction may well be genuine but it is open to question whether, in other instances, the non-allowable expenses were being hidden under other headings.
>
> Part of the problem arose from high marginal tax rates and the feeling on the part of business men that they were being denied relief in respect of expenses which they considered it necessary to incur. There was dissatisfaction with the arrangements and the view could be taken that they would not be successful in achieving the objective desired".

31.22 This provision is impossible to administer effectively. There is no equity in provisions which cannot be enforced. As a matter of general principle, we consider that entertainment expenses wholly, exclusively and necessarily incurred for business purposes should be allowed as a deduction to the business entity. Any benefit arising to individuals should be charged to them as a benefit-in-kind, but only to the extent that the Revenue Commissioners are satisfied that the expenses incurred are unreasonable and unacceptable.

31.23 There seems little alternative to facing the reality that income under Schedules D and E are entirely different concepts and that there is no easy method of relating them. Therefore, any surcharge on Schedule D income would be so arbitrary as to raise new issues of equity. We cannot recom-

mend such an approach. Any surcharge would also give rise to complicated rules of apportionment in mixed income cases. Account should also be taken of the fact that Schedule D taxpayers generally have much higher compliance costs than Schedule E taxpayers.

31.24 As regards Schedule D and Schedule E income, we consider that our recommendations go a significant distance towards removing any favourable treatment of Schedule D income. The change in the basis of assessment is the major factor in doing this. On the basis of the figures in Table 9, the average increase in tax payable on income between £5,000 and £10,000, if income increases by 10 per cent per annum, is 16.7 per cent. On the assumption that money incomes increase at 15 per cent per annum, this change to a current basis of assessment would increase the tax payable at existing rates of tax by the average self-employed person by 25 per cent per year.

Payment of Tax

31.25 Where different categories of income are subject to different arrangements for payment of tax, considerations of equity must be taken into account. Since 1960, most employees have paid tax under PAYE, under which they have tax deducted when remuneration is paid, whether weekly, fortnightly, monthly or otherwise. This system was extended in 1976 to certain employees, mainly in the public sector, who up to that time were outside its scope and paid tax on a preceding year basis quarterly in arrears.

31.26 The arrangements for payment of tax by self-employed individuals are rather complicated. Tax due is payable in a single payment on 1 October in the year of assessment. Farmers pay in two equal instalments on 1 October and 1 January in the year of assessment. Where income tax payable by direct assessment is not paid within two months of the due date, interest is charged at the rate of 1.25 per cent per month simple interest. Sub-contractors in the construction industry, who do not hold a certificate of authorisation from the Revenue Commissioners, are subject to a withholding tax of 35 per cent on all payments to them by principal contractors. Claims for repayment of the appropriate proportion of this tax may be made monthly.

31.27 Where liability to tax has not been determined before the due date, an estimated assessment will normally have been issued by the inspector of taxes. If the taxpayer considers that an estimated assessment is excessive, an appeal may be lodged against it pending the submission of a return of income, accounts or other information in support of the appeal. When appealing, the taxpayer must specify the amount of tax which it is considered will be payable when the appeal is determined finally and the liability

is agreed. If in his appeal, the taxpayer does not specify any amount, the total tax charged in the assessment is taken to be the specified amount. Where an amount other than the tax charged is specified no interest is payable provided that

(i) the specified amount is paid within two months of the due date, and

(ii) the specified amount proves to be at least 80 per cent of the total amount found to be payable when the appeal has been determined, and

(iii) any balance of tax due is paid within two months of the determination of the appeal.

31.28 Where the specified amount is the total tax charged in the assessment, no interest is payable provided that

(i) the total amount charged is paid within two months of the due date, and

(ii) any balance is paid within two months of the determination of the appeal.

31.29 Where an overpayment of tax results from payment of the specified amount, this is repaid with interest from the date of payment to the date of repayment. Interest on this type of overpayment is 1.25 per cent per month simple interest and this interest is not chargeable to tax. The effect of these provisions is that, in order to have avoided interest charges, self-employed taxpayers must have paid at least 80 per cent of their ultimate liability or the amount assessed (whichever is the lesser) before the end of the tax year.

Provisional Payments of Tax

31.30 We have concluded that all income should be charged to tax on the basis of the income arising in the current fiscal year. This would require the institution of provisional payments of tax unless there were to be unacceptable delays in payment of tax. This is because trading accounts are not available for some time after the end of the year to which they relate.

31.31 We recommend that a system of provisional tax payments should be applied to all individuals who are subject to direct assessments to tax. This would require interim payments by such taxpayers during the fiscal year in anticipation of final assessment to tax after the close of the year.

31.32 There are two basic methods which could be applied to a provisional system. The first would require that the interim payments would be based on assessments issued by the Revenue Commissioners. To deal with cases

where the estimated tax was excessive there would have to be provision for appeals and for a procedure akin to the present system of specified amounts. In cases where the estimated tax was too low, the Exchequer would be at a loss. This could happen in a significant number of cases as the latest accounts available when estimated assessments were being drawn up could be significantly out of date.

31.33 The alternative method is to require taxpayers to operate a system of self-assessment similar to that for which they may opt under the present arrangements for making payments on account. Such a system operates in the United States. At present, we understand that the payment on account procedure works well in Ireland. In principle, we would favour a self-assessment procedure since a taxpayer is likely to be the best judge, or even indeed the only judge, of how his business is progressing on a current basis. The institution of such a system might also enable the payment of tax to be advanced to a greater extent than one based on prior assessment by the Revenue Commissioners. However, in the initial stages at least, we recommend that the present system of assessments be continued.

31.34 We also believe that self-employed persons should make more frequent payments of tax. This would avoid the need for them to pay large sums in one lump. It would also bring self-employed taxpayers more into line with PAYE taxpayers. An acceptable compromise between the demands of equity, convenience of taxpayers and administrative considerations would be to require the self-employed to make four equal payments of provisional tax on or before 5 July, 5 October, 5 January and 5 April in the year of assessment. Final adjustments to provisional tax would be made as soon as possible after the end of the year of assessment. Special rules might be necessary for taxpayers who can show that the bulk of their income accrues in the second half of the fiscal year.

Amount of Tax Payable

31.35 At present, Schedule D taxpayers are obliged to pay by the due dates 80 per cent of the tax demanded in the assessment or of the amount ultimately found to be due, if interest charges are to be avoided. The balance of tax is payable when the assessment is finalised.

31.36 PAYE taxpayers normally pay their liability in full by the end of the year of assessment. A superficial analysis would suggest that Schedule D taxpayers should also be required to pay 100 per cent of their liability before the end of the year to avoid interest charges. Schedule D income is not identical to PAYE income which is available for spending immediately it is received. Schedule D profit may be tied up in increased stocks or working capital. In principle, we consider that Schedule D taxpayers should

deduct tax under PAYE on their drawings from the business and pay the balance of tax due on their profits after the end of the year of assessment.

31.37 We do not believe that this ideal approach can be operated in practice. The drawings from the business may not be known until after the end of the year. For example, in the case of expenditure which has both a business and personal element, the amount referable to private use will not be ascertainable until finally agreed with the inspector of taxes. We see little alternative to a rule of thumb. On this basis, we suggest that provided self-employed persons paid 80 per cent of the liability ultimately found to be due in the year of assessment, and the balance within fourteen days of the assessment being finalised, no interest should be payable.

Rates of Interest

31.38 At present, the rate of interest on under-payments and over-payments of tax is 1.25 per cent per month simple interest. Interest is not charged to tax as income and is not allowed as a deduction for tax purposes. The rate of interest charged, which is equivalent to an annual pre-tax rate of interest of 23.1 per cent at the standard rate of tax of 35 per cent, is intended to be a punitive rate of interest to discourage late payment of tax. Under a provisional tax system, it would no longer be appropriate to charge penal rates of interest as a matter of course. The rates of interest payable should generally correspond with market rates. We recommend that the rate of interest be the same as the rate charged on personal overdrafts by the Associated Banks.

31.39 We have considered the possibility of having different interest rates for under-payments and over-payments of tax. We believe that the rate at which interest is charged must be related to prevailing rates of interest on borrowings. If the rate of interest on overdue tax is less than that charged on other borrowings, taxpayers will use available cash to reduce borrowings rather than to pay tax. It could be argued that the rate at which interest is paid should be related to the rates available on deposits. If the rate at which interest is paid exceeds the rate available on other deposits, taxpayers may be encouraged to over-pay tax in order to receive refunds at favourable rates of interest. We recommend that the same rate of interest should be payable on both under-payments and over-payments of tax. To have a lower rate of interest on over-payments would be widely seen by the public as unfair. In addition, account must be taken of the saving to the Exchequer arising from the reduction in public borrowing which would result from over-payments of tax.

31.40 We have considered the possibility of instituting a two-tier system of interest charges with a higher penal rate being applied to tax underpaid or overpaid after a certain date following the year of assessment. We believe

that a case can be made for charging a higher penal rate of tax outstanding after, say, two years from the end of assessment. Such a rate should only apply to under-payments of tax. If applied to over-payments it would be open to abuse.

31.41 At present, interest on under-payments or over-payments of tax is disregarded for income tax purposes. We consider that the treatment which we have recommended in Chapter 11 for interest generally should apply to interest on under-payments and over-payments of tax.

Period of Grace

31.42 At present, interest is waived on tax due which is paid within two months of the due date regardless of the amount involved. There is a proposal in the Finance Bill, 1982 to reduce this to one month for corporation tax only. We understand that it is the practice among large companies to delay, quite legitimately, the payment of tax until the end of the two month period. At current rates of interest (1.25 per cent month), the interest waived on a sum of £1 million is £25,000. When the rate of interest charged is not penal the need for a period of grace is reduced. We consider that the two months period of grace should therefore be abolished. If it is necessary for administrative reasons to avoid the collection of small amounts of interest, this should be done by writing off amounts below a certain figure.

Rates on Business Property

31.43 Rates paid on business property may be regarded as either a tax on the imputed rental income arising from the occupation of the property or as an annual tax on capital. If they are regarded as a tax on capital, it seems difficult to justify charging a tax on some forms of capital but not on others. We regard rates as a tax on income. The statutory basis for rates is the net annual rent of the property, which supports our view. On this basis, to levy rates on business property and to charge income tax on the profits of the business constitutes double taxation and leads to a waste of resources. Since rates in Ireland are neither general nor uniform, it is likely that a significant part of the burden of rates is shifted and results in higher prices of goods and services produced in commercial property subject to rates. We recommend that rates paid be granted as a credit against income tax payable on the profits of the business. This does not preclude the possibility of rates on commercial property being a major source of local taxation in the future. We will deal with the question of local taxation in a later report.

Recommendations

31.44 We make the following recommendations:

1. All income as defined should be charged to tax for a year of

assessment on the basis of the income arising in that year of assessment.
2. Business expenses should be deductible only when they are laid out wholly, exclusively and necessarily for the purposes of a trade or profession.
3. Taxpayers subject to direct assessment should be required to make provisional tax payments in four instalments during the year of assessment. The provisional tax should amount to 80 per cent of the lesser of the amount assessed or ultimately found to be due, in order to avoid interest charges.
4. The balance of tax due should be payable within fourteen days of the assessment being finalised, in order to avoid interest charges. Reciprocal arrangements should apply where tax has been overpaid.
5. Motor expenses which are incurred wholly, exclusively and necessarily for business purposes should be allowed in full in computing the profits of the business entity.
6. In cases in which motor vehicles are used by self-employed persons, consideration should be given to restricting business motoring costs to the scale rates set down for employees.
7. Entertainment expenses which are incurred wholly, exclusively and necessarily for business purposes should be allowed in full in computing the profits of the business entity. Any private benefit arising to individuals should be charged to them as a benefit-in-kind, to the extent that the Revenue Commissioners are satisfied that the expenses incurred are unreasonable and unacceptable.
8. Interest should be paid on underpayments and overpayments of tax at a rate equivalent to the rate charged on personal overdrafts by the Associated Banks.
9. A penal rate of interest should be applied to tax which has not been paid to the Revenue Commissioners after two years from the end of the year of assessment or the finalisation of the assessment if later.
10. Interest payable on late payments of tax whether by the Revenue Commissioners or the taxpayer should be treated for tax purposes in the same way as other interest.
11. The two months period of grace before interest becomes payable should be abolished.
12. If it is necessary for administrative reasons to avoid the collection of small amounts of interest, this should be done by legislation authorising the writing off of amounts below a certain figure.
13. Rates paid on business property should be allowed as a credit against income tax payable on the profits of the business.

CHAPTER 32

FARMING PROFITS

Introduction

32.1 In this chapter we consider the main issues that require to be settled in determining the general taxation system which should apply to farming profits. We will consider the question of incentives for agriculture in a later report. In general, equity requires that the same principles of taxation should apply to farmers as to other taxpayers, in so far as this is possible. Departures from the treatment implied by this principle may imply inequitable treatment of farming and would require specific justification. For this reason, the general structure of taxation which we have recommended in Chapter 31 for self-employed persons should also apply to farmers. The historical background to the present system of taxation of farming profits is set out in Appendix 25.

Agriculture in the Irish Economy

32.2 Agriculture is Ireland's most important industry. It accounts for about 12 per cent of gross domestic product and for about 18 per cent of the total at work in direct employment. A description of the role of agriculture in the Irish economy is set out in Appendix 26.

The Issues

32.3 The main issues which require to be considered in relation to the taxation of farming profits are

(i) the determination of farming income;

(ii) the existing exemption of certain farmers from income tax;

(iii) the question of rates on land;

(iv) the question of a resource tax;

(v) the question of a system based on imputed profits, and

(vi) the arrangements for payment of tax.

The Determination of Farming Income

32.4 In general, we consider that income from farming should be

determined on the same basis as income from any other business. Our recommendations in Chapter 26 apply equally to farming as to any other business. However, two issues require special comment. At present, free depreciation on certain farm machinery and plant is restricted so that the total capital allowances cannot exceed 30 per cent of the farming profits. This restriction discriminates against farmers and should be removed.

32.5 The second issue relates to the question of stock valuations. In order to deal with this issue it is necessary to distinguish between trading stock and breeding stock. Trading stock largely comprises the farm produce, e.g. milk, calves, etc. which the farmer sells to earn his living. Breeding stock comprises the basic herd or flock which produces the output which the farmer can sell and as such is equivalent to a capital asset.

Present System of Valuing Stock

32.6 All livestock and farm animals are, under the present system, treated as trading stock. According to the Revenue Commissioners any method for the valuation of livestock based on cost or net realisable value is acceptable to them provided that it is applied consistently. Farmers' representatives claim that this is not being operated in practice in the districts. For farm animals reared on the home farm, or bought at such time that their present value bears no relation to the original purchase price, a method of adding up all the costs of feeding and maintaining the animals would be one possible way of ariving at cost value.

32.7 It has been recognised that few farmers would have the time or resources to keep the detailed records needed to establish accurately the cost of producing each separate animal up to the accounting date. Accordingly, as an alternative arrangement, the Revenue Commissioners have been prepared to accept estimates of cost arrived at on the following basis:

(i) 60 per cent of the market value of cattle bred on the farm or purchased as immature stock;

(ii) 75 per cent of the market value of sheep and pigs bred on the farm or purchased as immature stock, and

(iii) 75 per cent of the market value of the harvested crops. Growing crops need not be valued.

This method of valuing stock operates in virtually all cases.

Trading Stock

32.8 In principle, trading stocks in farming should be separated out from breeding stock and valued for the purposes of computing farming

income on the same basis as the trading stock of any other business, that is, at the lower of cost or net realisable value. A permanent cost of sales adjustment as recommended in Chapter 26 should also apply to trading stocks in farming. The option of using the existing notional basis for arriving at cost should be retained.

Breeding Stock

32.9 Breeding stock is a capital asset and since the breeding animal has a limited useful life the correct approach in principle would be to grant capital allowances in respect of each animal, spread over its useful life. Under our proposals in Chapter 26, these allowances would be indexed. Profits on the sale of breeding stock would give rise to balancing charges and/or liability to capital gains tax, while losses would give rise to balancing allowances. We recommend that this treatment be applied to breeding stock in the case of those farmers who formally establish breeding herds or flocks. The formal establishment of a breeding herd or flock should be a decision which is left entirely to the discretion of each individual farmer. Those farmers who do not formally establish breeding herds or flocks should continue to have their livestock treated on a trading stock basis.

Incentives to Increase the National Herd

32.10 It has been suggested to us that incentives are required to increase the size and quality of the national herd. We will consider this question in a later report. It is essential that any incentives which may be given achieve their purpose in a way which is cost effective as far as the Exchequer is concerned. In Appendix 27 we outline a number of possible incentive schemes for farming stock.

Exemption of Certain Farmers from Income Tax

32.11 Broadly speaking, farmers with a rateable valuation of £40 or under are not liable for income tax regardless of their farming incomes, while those with a rateable valuation of between £40 and £49 pay a fraction of the tax that would in the normal course be payable. We conclude in paragraph 32.17 that there is no direct relationship between farming income and the rateable valuation of land occupied. Therefore, it is clearly inequitable to exempt farmers from tax on this basis. All farmers should, in principle, be subject to income tax on the same basis as other individuals. This does not mean that all farmers would in fact pay tax. If their income were below the exemption threshold, they would be

excluded by the Revenue Commissioners on the same basis as employees or other self-employed persons.

Rates on Land

32.12 We received submissions that to levy rates on land is unfair. These argued that the land valuations upon which agricultural rates are based are inequitable and that rates do not take account of a farmer's ability to generate a taxable income.

32.13 Rates are levied on the amount of rateable valuation of land. The basis of rateable valuation in Ireland is contained in the Valuation (Ireland) Act of 1852 which sets out to provide "one uniform valuation of lands and tenements which may be used for all public and local assessments and other rating". The Act specified that the net annual value of agricultural land be estimated by reference to the average price for the years 1849/51 of the main crops and produce of the time, on the assumption that the tenant paid all rates, taxes and other charges, except tithe rent charge. The valuers were instructed to take into account local circumstances such as aspect, elevation, ease of communication, distance from a market town and all other factors which might affect the production or sale of farm products.

32.14 The valuation under the 1852 Act, which was conducted under the direction of Sir Richard Griffith, is generally known as "Griffith's Valuation". It began in 1852 and was completed in 1865. Almost from the time Griffith's Valuation was completed there was concern about its adequacy. It soon became clear that, although valuations within counties probably reflected fairly well the relative productivity of the various parts, there were discrepancies when it came to making comparisons between counties. One important reason for this was that the valuation commenced in the South in 1852 when conditions were at a low ebb after the Famine and was completed in the North in 1865 when conditions had improved. As early as 1869, the Commissioner of Valuation was of the opinion that a number of counties needed their valuations increased by between 12½ pence and 25 pence an acre in order to bring them into line with the valuations in such northern counties as Cavan, Donegal and Monaghan. The average valuation of land fixed by Griffith was 41 pence per acre for the country as a whole. In 1931, the Commission of Enquiry into Derating concluded that the valuations (both absolute and relative) of agricultural land were not in accordance with contemporary relative values.

32.15 The inequity of present land valuations has been borne out repeatedly by a series of independent studies. The Commission on

Income Taxation in its Fourth Report[1] made estimates of income per pound of valuation of land and farm buildings for 1959 ranging from £10.3 for farms over 200 acres and £17.2 for farms between thirty and fifty acres. Attwood and Geary[2] have estimated that, for the year 1960, income in agriculture per pound of land valuation varied from £37.7 in County Kerry to £12.3 in County Monaghan. The average figure for the country as a whole was estimated to be £18.6. Statistics in relation to 1973 based on estimates of personal county incomes made by Ross and Jones[3] also support the conclusion that there are serious anomalies in the relationship of land valuations to farm incomes. These show that income arising in agriculture in 1973 per pound of land valuation averaged £57.1 for the country as a whole. The county estimates ranged from £31.1 in Westmeath to £109.8 in Kerry.

32.16 A number of other studies support the conclusion that land valuations no longer reflect accurately land potential and farm income differences. In an Agricultural Institute Study[4] which investigated the relationship between rateable valuation, soil type, stocking performance and farm income on a sample of 127 farms in four counties, a significant relationship was found between soil type and stocking rate and between soil type and family farm income. No significant relationship was found between valuation and either income per acre or soil type. Another Agricultural Institute Study[5] examined the data for Wexford and concluded that the distribution of valuation about the mean was very wide within each soil series examined, and that there was a lack of proper differential in valuation between soil series. Chambers[6] has noted the disparities in press reports of farm sales between the price per acre of agricultural land and the rateable valuation. On the basis of this evidence McArthur and Reid[7] conclude that

> "there seems no reason to doubt the fact that farmers in similar circumstances regarding the size of their farms and the quality of their land can find themselves paying greatly different rates under the present arrangements".

32.17 We are satisfied that the present land valuation system is not an acceptable basis for taxation purposes. It is unreliable as a yardstick for the measurement of market value, letting value, fertility of the soil,

[1] Prl. 5731. Appendix 3. Table 5.
[2] E.A. Attwood and R.C. Geary *"Irish County Incomes in 1960"* ESRI Paper No. 16 Table 12.
[3] M. Ross and R. Jones. *Personal Incomes by County in 1973*. NESC Paper. No. 30 Prl. 5933.
[4] J. Frawley. *"The Poor Law Valuation as a Basis for Welfare Administration and Local Taxation"*. Irish Journal of Agricultural Economics and Rural Sociology. Vol. 4. No. 1. 1972/73.
[5] J. Lee and J.P. Haughton. *"Observations on Tax Assessment of Agricultural land in Wexford County"* Irish Journal of Agricultural Economics and Rural Sociology. Vol. 1 No. 2 1968.
[6] A. Chambers *"Agricultural Land Prices and Rateable Valuation — A Note"*. 1975 Mimeo.
[7] *The Taxation of Farming Profits*. NESC Report No. 15. Prl. 4912 p. 84.

development potential or anything else that might have relevance to taxation. We recommend, therefore, that the use of existing rateable valuations to determine tax liability in any way be discountinued as soon as possible.

32.18 We now consider whether rates should continue to be imposed on land on the assumption that they are levied on the basis of an equitable valuation system. In broad terms, rates paid on land may be regarded as either a tax on the imputed rental income arising from the occupation of property or as an annual tax on capital. If they are regarded as a direct tax on income, the case must be conceded that to levy rates on land and income tax on farming profits simultaneously constitutes double taxation. Alternatively, if rates on land are regarded as a tax on capital it seems difficult to justify charging a tax on some forms of capital and not on others. If it is desired to impose a tax on capital, such a tax would be levied more equitably in the form of an annual wealth tax on all forms of capital rather than in the form of rates on a restricted base.

32.19 Historically, rates have been regarded as a tax on income. Provided all farmers are liable for income tax there is no case in principle for imposing rates on land. On this basis, we recommend that rates on land be abolished. In any interim period, rates payable should be allowed as a credit against income tax due on a current basis.

Resource Tax

32.20 We received submissions which argued for, and others which opposed, the imposition of a resource tax on agricultural land.

32.21 The economic argument for a resource tax rests on the fact that farmers possess a valuable resource and that they should be forced to maximise the productive potential of this resource (land) in the national interest. To operate effectively, a resource tax would have to be fixed at a level which would make it uneconomic for inefficient farmers to continue in business and force them to dispose of their land to persons who would make better use of it.

32.22 The possession of valuable resources is not confined to farmers. Many individuals have such resources — often in the form of human capital in which the State has invested heavily through the provision of educational services to the beneficiaries at less than the full economic cost of these services. To impose a resource tax on a general basis would be impossible in practice. Many would find the concept unacceptable in principle due to the substantial erosion of freedom implied in it.

32.23 We believe that there is no justification for imposing a resource

tax on farmers on equity grounds. In our report on incentives, we will consider the problem of the underutilization of land and whether or not this should be tackled by taxation measures.

Production Unit Accounting

32.24 We received representations that farmers should be given the option to be charged to tax on the basis of imputed rather than actual profits. The IFA/ICMSA proposed a production unit accounting system which would take account of variations according to farm size, soil type, region and system of farming. The objective of providing an option for assessment on a notional basis would be

> "to retain the drive, initiative and dedication of those farmers engaged in sectors demanding intensive labour involvement and expertise".

32.25 In general, the production unit accounting system would operate as follows. The average profit either per acre or per unit of livestock, whichever is considered more appropriate, would be calculated for a series of representative farms which would be expected to reflect the varying farm sizes and systems of production found in the Irish agricultural sector. It is proposed that the data to be used for this purpose would be those which are collected annually by the Agricultural Institute for the purpose of compiling the Farm Management Surveys. All farms in the country would be classified by system of farming and the relevant "average profit" factor would then be applied to each farm in the country and in that way the taxable profit of each farmer would be derived. The actual number of units of production, e.g. number of cows, number of sows, cereal acreage would be multiplied by the relevant income factors as identified by the Farm Management Survey to give the total income of the farm.

32.26 The alternative method of taxing farming profits is on the basis of actual profits as shown by accounts. These alternative systems are now evaluated by reference to the criteria of equity, efficiency and simplicity.

32.27 Equity requires that persons be charged to tax on the basis of their ability to pay. Under an income tax system, this ability to pay is measured by the level of income. Under a system of production unit the income charged to tax would in almost every case be different from actual income. The system would therefore be less desirable on equity grounds than one which based the charge to tax on actual profits.

32.28 The chief merit claimed for production unit accounting, or indeed any system based on notional income, is that it would encourage

increased efficiency and would involve lower compliance costs for farmers. To the extent that this occurred it would be caused by two factors. Firstly, farmers of below average efficiency would be taxed on a higher income than they actually earned. They might then be forced either to sell or lease their land to someone who would use it better or increase their efficiency. Secondly, since the tax payable by each farmer would not vary with his income, he would retain all the gains from increased production above the established norm.

32.29 The question arises whether or not farmers would be granted an option to be charged to tax on the basis of accounts. If this were conceded, there could be no gains in efficiency from inefficient farmers.

32.30 The effect of taxation upon the level of agricultural output is far from clear. The case for a tax which is invariant with respect to the level of income, compared with a tax on income, rests on the basis that the substitution effect outweighs the income effect of a change in the taxation system. If a farmer is considering whether to work harder in order to increase his income, he will bear two considerations in mind. On the one hand, if his additional earnings are taxed, then clearly it becomes less worthwhile to put in the extra effort; the farmer may substitute leisure for effort (the substitution effect). On the other hand, the farmer may well aspire to a certain standard of living and require a certain level of income to achieve it. If this is the case, he may decide to work even harder to maintain his after-tax income (the income effect).

32.31 Empirical work on the relative strengths of the income and substitution effects has not involved farmers who may be a special case. In general, the available evidence suggests that taxation has little effect on the amount of work done.[8]

32.32 The effect of taxation on investment is more complex. Taxation of income may reduce investment because the after-tax rate of return is reduced and because the cash flow is diminished, thus making the financing of investment more difficult. The impact of taxation is reduced if depreciation allowances are a feature of the tax system, in which case part of the cost of investment is met by the State. Taxation of marginal income may encourage investment, in that the farmer may consider it preferable to invest surplus cash in his farm rather than increase his consumption having paid a slice to this surplus to the Revenue Commissioners.

32.33 On the basis of this analysis, we believe that a system of

[8] *Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour*. OECD 1975.

production unit accounting would be a far more effective instrument for encouraging increased production if applied to relatively inefficient farmers. However, under a system which allowed farmers to opt for either taxation on a notional basis or on the basis of actual profits, efficient farmers will opt for the notional basis while inefficient farmers will opt to be charged on actual profits.

32.34 A scheme of production unit accounting would have to be based on the Farm Management Survey. There could be a risk if this survey were to be used for taxation purposes that it might reduce the co-operation of farmers in compiling it. Also, the criteria for classifying farmers into the appropriate system of farming would be difficult to incorporate into legislation and this would give rise to argument, particularly in the case of mixed farms. Furthermore, it could be difficult establish the number of production units as these vary throughout the year in certain sectors of farming.

32.35 One of the arguments advanced in favour of production unit accounting, or indeed any notional system of taxation, is that it would reduce compliance costs for farmers by relieving them of the obligation to keep accounts. This would only arise if there were no option to be taxed on the basis of actual profits. We consider that the requirement to produce accounts does not impose an unreasonable burden on farmers. Farmers like all other traders are required to keep records of their transactions on which accounts may be based. It is desirable that this be done in any event for reasons quite unconnected with taxation.

32.36 It is sometimes stated that farmers are obliged to incur substantial audit and accountancy fees solely for the purposes of establishing that they have little or no liability to tax. We raised the matter with the Revenue Commissioners who assured us that once it becomes clear that a farmer has a low income and will not be liable to tax no assessments are raised for a period of years. There is no requirement to produce annual accounts in cases in which there is clearly no liability to tax. The Revenue Commissioners assured us that they do not insist on the preparation of accounts by a professional accountant until it becomes clear that a farmer (or indeed any other businessman) is in a substantial way of business or making significant profits.

Conclusion

32.37 We conclude that the introduction of a system of production unit accounting would be both unfair and unworkable. The evidence on the economic benefits flowing from such a system is uncertain. We cannot therefore recommend such a system.

Arrangements for Payment of Tax

32.38 We noted earlier that special arrangements for payment of tax might be necessary for taxpayers who receive the bulk of their income in the second half of the fiscal year. One category which we have in mind here is farmers. While the normal rules provided for self-employed persons should generally apply, farmers should be permitted by arrangement with the Revenue Commissioners to pay tax within the year of assessment in a way which would fit in with their cash flow.

Recommendations

32.39 We make the following recommendations:

1. The same general system of taxation should apply to all farmers as to all other self-employed persons.
2. The use of existing rateable valuations to determine tax liability in any way should be discontinued as soon as possible.
3. Rates on land should be abolished. Pending their abolition, rates payable should be allowed as a credit against income tax due on a current basis.
4. Special restrictions on the capital allowances available to farmers should be removed.

CHAPTER 33

INVESTMENT INCOME

Introduction

33.1 In this chapter we examine the present system for the assessment and payment of tax on investment and rental income and conclude that it is inequitable and unnecessarily complicated in a number of respects. We recommend that all investment and rental income be assessed to income tax on a current year basis. We also consider and reject the introduction of a surcharge on investment income. Our proposals for the determination of certain investment income are set out in Chapter 11.

Definition

33.2 Investment income is not defined in the legislation. Generally speaking, however, it is taken to include dividends, interest, annuities (if not paid under approved retired annuity contracts) and rents.

Assessment of Tax on Investment Income

33.3 For the purposes of assessment, investment income is classified according to its source and is charged to tax under the following schedules:

(i) *Schedule C:* This covers certain interest, annuities and dividends payable out of public revenues in the Republic of Ireland or elsewhere which are taxed at source, e.g. land bond interest.

(ii) *Schedule D — Case III:* This covers certain dividends, interest and annuities, including income from foreign securities and foreign rental income, which have not been taxed at source or under Schedule C, e.g. Irish Government loans and ordinary shares of United Kingdom companies.

(iii) *Schedule D — Case IV:* This covers certain income (e.g. annuities, foreign income, building society deposit interest) from which tax has or is deemed to have been deducted at source.

(iv) *Schedule D — Case V:* This covers rental and easement income from premises in the State.

(v) *Schedule F:* This covers dividends and distributions paid by Irish resident companies.

Schedule C

33.4 Schedule C applies to paying agents who pay out the defined interest, annuities or dividends. They must deduct tax at the standard rate and pay the net amount to the persons entitled to the interest etc.. Assessments under Schedule C are then made on the paying agents in respect of the tax deducted. The basis of assessment is the actual Schedule C income paid in the tax year. The recipient of the net income is assessed to tax on the gross sum with credit for the tax withheld. We will examine the question of deduction of tax at source in a later report.

Schedule D — Case III

33.5 Case III income is assessed normally on the basis of the income of the preceding tax year, subject to commencement and cessation provisions similar to those which apply to other Schedule D income. Except where paid to non-residents, income under this heading is not liable to income tax by deduction. Instead, it is paid gross and is assessed to income tax in the hands of the recipient.

Rental Income

33.6 Tax is charged (normally under Case V of Schedule D) in respect of rents from any premises in the State. In arriving at the chargeable income, the following expenses may be allowed against the gross rents receivable:

(i) Rent payable on property,

(ii) Rates payable on property,

(iii) Cost of services rendered,

(iv) Repairs, insurance, maintenance and management,

(v) Interest on money borrowed to purchase, improve or repair property, and

(vi) Wear and tear of furniture and fittings[1].

As with Case III the income generally assessable for a year of assessment is the income of the preceding tax year. There are special rules governing the commencement and cessation of the source.

Schedule F

33.7 Under the existing Irish corporation tax, a dividend or other distri-

[1]There is no statutory basis for this deduction — it is granted by way of revenue practice.

bution paid by an Irish resident company carries a tax credit. The recipients of the distributions are assessable on the aggregate of the distribution and the associated tax credit. The normal tax credit is currently 30/70 ths of the distribution. The recipient is entitled to deduct from his individual tax liability the tax credit attaching to the distribution. The assessment is based on the actual amount of distribution made in the tax year.

Basis of Assessment

33.8 We noted in Chapter 31 the inequities which may arise in periods of inflation when some incomes are assessed on a current year basis and others are assessed on a preceding year basis. The position in relation to the assessment of investment income is particularly confusing to the taxpayer in that some forms of investment income are assessed on a current year basis while others are assessed on the basis of the income of the preceding year. We recommend that all investment income be charged to tax on a current year basis.

Payment of Tax

33.9 We recommended in Chapter 31 that self-employed persons be required to pay 80 per cent of the tax ultimately due from them before the end of the year of assessment, in order to avoid interest charges. In principle, it would be reasonable to expect recipients of investment income to pay 100 per cent of the tax due during the course of the year to avoid interest charges. This is because such income can often be more easily be predicted than other income from self-employment and is available for immediate consumption. However, to facilitate administration and to avoid difficulties for taxpayers in mixed income cases, we recommend that the same arrangements for payment of tax should apply to investment income as we have recommended for income from self-employment.

Investment Income Surcharge

33.10 We received submissions which proposed that differentiation be introduced between earned and unearned income, either in the form of an earned income relief or an investment income surcharge.

33.11 In 1907, a distinction for tax purposes was introduced between earned and unearned income. The differentiation in favour of earned income was originally based on the fact that it is "precarious", that is, that earned income is less stable than investment income and that it depends on the recipient being able to give services in return for it. It is dependent on effort

and is affected by old age, sickness or other disability. The relief was later also justified on the ground that there is an element of expense involved in obtaining remuneration from work that is not present in obtaining investment income and that the expense cannot be completely allowed for by deductions for expenses in tax assessment.

33.12 In 1907, earned income relief was limited to incomes of £2,000 and under. The Dilke Committee[2] which had examined the question was troubled by the problem of the owner of the unincorporated business. Was his income earned income or investment income from his capital, or rather, what were the proportions involved? They adopted the principle that the smaller the business and the smaller the profit derived from it, the larger will be the proportion of that profit which is truly earned; the more extensive and remunerative the business on the other hand, the larger, as a rule, is the part that capital plays in it and the more practicable and equitable it becomes to treat the profit derived from it as income from an investment. On the basis of this principle, they produced the rather arbitrary recommendation that differentiation between earned and unearned incomes should be limited to incomes not exceeding £3,000 a year. A limit of £2,000 was enacted so that no taxpayer with an income in excess of the figure could claim the relief. The Royal Commission on Income Tax, 1920, while recognising that there was no completely logical reason for the limitation, recommended[3] £2,000 as the limit of the amount of earned income which could rank for relief, whatever the total income of the recipient, instead of the former system of giving or withholding the relief altogether according to the amount of total income.

33.13 The question of differentiation was considered by the Commission on Income Taxation[4] which took the view that, because the recipient of unearned income usually owns the capital from which it is derived, it is reasonable to tax unearned income more heavily than earned income, but that would not be warranted if the capital itself were taxed as well as the income. Since in Ireland there was no recurring tax on capital (except estate duties), a heavier tax on unearned incomes was justified. The Commission noted that with the general improvement in social services those who have

> "little or no capital need not concern themselves as much as previously to provide for their maintenance during illness, unemployment and old-age. Furthermore, contributions towards retirement and medical-benefit schemes, as also premiums for both pure life and endowment assurance, are deductible in large part from income tax;

[2]Report from the Select Committee on Income Tax chaired by Sir Charles Dilke, Cmd. 365, November, 1906.
[3]Cmd. 615, para. 113.
[4]Seventh Report, Pr. 6581, 28 March, 1962, paras. 6 to 15.

and so far as the earned income allowance provides for such matters there is a double allowance for income taxation".

The Commission recommended no change in the earned income relief due to the fact that it regarded "the present differentiation as adequate".

33.14 In any discussion of this subject it is frequently assumed that taxpayers are divided into two classes: those with wholly earned income and those with wholly unearned income. In fact, the truth is that the vast majority of taxpayers who hold unearned income also receive earned income in significant amounts. This fact assumes great significance if the structure of the earned income relief since the foundation of the State is examined. This shows that in order to qualify for the maximum earned income relief a taxpayer had to have £2,000 of earned income in 1922/23. Once this amount of income was earned, it was a matter of complete indifference to the taxpayer whether the remainder of the income was earned or unearned. This figure was reduced to £1,700 in 1932 and to £1,500 in 1939. It was increased to £1,800 in 1952 and to £2,000 in 1961. It remained at that level until earned income relief was abolished in 1974. Therefore, in 1973 differentiation only affected those taxpayers with an earned income of less than £2,000 who also had a source of unearned income.

33.15 It would seem that the taxation of unearned income prior to 1974 bore heavily on many persons living on small fixed investment incomes and was unduly harsh at a time when the value of their savings was being eroded through inflation. It bore heavily on some of those who invested in Government securities while those who took their returns in the form of capital gains escaped totally. Earned income relief was abolished in 1974 when the new unified structure of income tax was introduced in place of income and sur-tax.

33.16 A long-standing argument for treating earned income more leniently than investment income is its greater "precariousness". This is based on the idea that there is a limit to the number of years in which it will be received, whereas unearned income (at least from Government securities) can be expected to last indefinitely. However, the simple fact is that if one income of given amount lasts for a shorter period than another of the same amount, it is also taxed for a shorter period. To quote J.S. Mill:

> "When it is said that a temporary income ought to be taxed less than a permanent one, the reply is irresistible, that it is taxed less; for the income which lasts only ten years pays tax only ten years, while that which lasts for ever pays forever".[5]

[5] J.S. Mill, *Principles of Political Economy*.

33.17 If there is any argument for differentiating in favour of income simply because it may have a relatively short life, it would also apply to income from risk investments.

33.18 A further aspect to the precariousness argument has regard to the fact that such income may be interrupted by sickness or unemployment. This argument may have had greater force in earlier times before the introduction of pensions, sickness and unemployment benefits which now afford protection to those dependent on earned income.

33.19 It is argued that acquiring income through personal exertion involves greater effort than acquiring investment income. It is on this basis that it is sometimes argued that overtime earnings should be free of tax. If the income tax code were to try and charge income in proportion to the effort expended in acquiring that income it would quickly become immersed in trying to assess factors which in many cases are totally subjective. Capacity to pay is not influenced by the effort required to earn income. To attempt to relate income taxation to the effort expended in acquiring that income would be misconceived in principle and unworkable in practice.

33.20 Another argument suggests that earned income is in large part the return to investment in human capital of education and training and that if no depreciation on this investment is allowed there should be a differential rate of tax on earned income. The application of a system of earned income relief which makes no distinction between high incomes due to innate natural ability and those due to intensive training does not seem a very efficient means of allowing for investment in education and training. Such an allowance would also fail to take account of the fact that much of educational expenditure is financed by the State in any event.

33.21 The final argument is that possession of capital conveys advantages over and above those arising in the form of annual income from it. This suggests that people who own capital are in a far better position to spend in excess of annual income than those who possess no capital. An earned income relief does compensate for this factor but in a very imperfect way. It does differentiate between an earner and an investor each having the same income but it does not differentiate at all between two property owners each with the same income but with different amounts of capital. It is precisely the difference in the amounts of capital in people's ownership which is at issue here. If it is desired to distinguish between persons with different amounts of capital, the imposition of capital taxes would appear to be the best method of doing so. We consider the taxation of capital and capital transfers in Part IIC of the report. Any device which differentiates according to income must be arbitrary. Our proposals for a direct expend-

iture tax will take into account the additional consumption financed by persons out of capital. In our view, account need only be taken of the higher spending power arising from the ownership of capital to the extent that it is realised. We do not recommend the introduction of earned income relief or an investment income surcharge.

Recommendations

33.22 We make the following recommendations:

1. All investment income should be charged to tax on a current year basis.
2. The same arrangements should apply for payment of tax on investment income as those which apply to other income from self-employment.
3. Investment income should be charged to tax at the same rate as other income.

Part II C

The Taxation of Capital and Capital Transfers

CHAPTER 34

THE TAXATION OF GIFTS AND INHERITANCES

Introduction

34.1 In this chapter we consider the general system of taxation to be applied to gifts and inheritances. We conclude that gifts and inheritances should be taxed at the same rate as all other income.

Justification for Taxing Gifts and Inheritances

34.2 The allocation of taxes according to income requires that tax be charged on a base which measures the change in the economic power of each individual or family. We have defined this base as the amount which may be spent on consumption in a period without adding to or subtracting from wealth in real terms in the process. If all other income is taxed, equity becomes the main justification for gift and inheritance taxes, since receipts from gifts and inheritances confer the same command over economic resources as other income. In principle, therefore, gifts and inheritances should be charged to tax as ordinary income. Departures from this approach may be justified on two grounds only. Firstly, if income is charged at progressive rates on an annual basis, it would clearly be inequitable to charge gifts, inheritances and other windfalls without giving some relief because they occur in an irregular pattern. Secondly, reliefs may also be required on economic grounds because of the adverse effects on production and investment which may result from imposing such a charge.

34.3 A justification for taxing gifts and inheritances at a higher rate than all other income is that this provides a method of changing the distribution of wealth (however defined) in society. In Appendix 31 we examine the evidence regarding the existing distribution of wealth in Ireland. In Chapter 36 we consider the extent to which changes in this distribution might be thought necessary and examine how the tax system could contribute to such changes.

Historical Background

34.4 Prior to 1975, the taxation of property passing on death consisted of estate duty, succession duty and legacy duty. The provisions of these taxes

are set out in Appendix 28. Estate duty was payable at progressive rates on property worth over £7,500, subject to certain reliefs. Legacy and succession duties were payable on inheritances. Gifts were not liable for tax, except if made within five years of the death of the donor.

34.5 Proposals for the amendment of the taxation of gifts and inheritances were made in a White Paper[1] published in 1974. These proposals were enacted later. The Finance Act, 1975 repealed all death duties on property passing on deaths occurring on or after 1 April, 1975. The Capital Acquisitions Tax Act, 1976 introduced an inheritance tax in respect of property passing on deaths occurring on or after 1 April, 1975 and a gift tax on taxable gifts made on or after 28 February, 1974. The main provisions of the capital acquisitions tax are set out in Appendix 29.

Capital Acquisitions Tax

34.6 All taxable gifts and inheritances taken by an individual from a particular donor are aggregated for the purposes of the calculation of capital acquisitions tax, the most recent gift or inheritance paying tax at the rate applicable to the highest part of the aggregate. In the March, 1982 budget it was proposed that all gifts and inheritances received by a beneficiary from all sources would in future be aggregated to determine the tax liability on each benefit. The Finance Bill, 1982 modifies these proposals. Provision is now being made for the aggregation of all gifts and inheritances taken by a beneficiary from all disponers within the respective classes to which the tables of rates in the capital acquisitions tax are referable. The rates of tax payable on inheritances range up to 60 per cent and are set out in Appendix 29. Gift tax is charged at 75 per cent of the rate applied to inheritances. When a donee dies within two years of making a gift, then the gift is charged at inheritance tax rates. Any gift taken by a donee on or after 28 February, 1969 and before 28 February, 1974 is taken into account in determining the rate of tax applying to any further gift or inheritance from a particular donor.

34.7 Capital acquisitions tax is calculated on the market value (less certain deductions and reliefs) of the property of which the gift or inheritance consists. Agricultural property taken by a farmer, as defined, is valued for the purposes of the tax at half the market value subject to a maximum deduction of £150,000. It is proposed in the Finance Bill, 1982 to increase the maximum deduction to £200,000, with effect from 1 April, 1982.

34.8 The main exemptions from capital acquisitions tax are as follows:

[1] *Capital Taxation* Prl. 3688. February, 1974.

(i) the first £500 taken as a gift by a donee from a disponer in any one year to 31 December;

(ii) property taken for public or charitable purposes in Ireland;

(iii) works of art, scientific collections, libraries, houses or gardens provided that they are of national, scientific, historical or artistic interest and are kept permanently in the State and are open to public viewing.[2]

(iv) payments taken by way of retirement benefit, redundancy payment or pension;

(v) reasonable payments received in the disponer's lifetime by members of his family for support, maintenance or education or by a dependent relative for support or maintenance, and

(vi) certain Government securities when taken by foreign beneficiaries.

34.9 Capital acquisitions tax is an inheritance-type tax compared to an estate duty which is donor based. We examine the relative merits of these two forms of taxes in Chapter 36 in terms of their impact on the distribution of wealth. Leaving aside issues of redistribution, we favour an inheritance-type tax over an estate duty since this approach is consistent with the definition of the tax base which we have adopted.

The Issues

34.10 The main issues to be considered in relation to the taxation of gifts and inheritances are

(i) the unit of taxation;

(ii) relief for productive assets;

(iii) relief for assets which are not readily realisable;

(iv) agricultural land;

(v) the preferential treatment of gifts;

(vi) an exemption threshold, and

(vii) relief for consanguinity.

The Unit of Taxation

34.11 The individual, not the wider family unit, is the basis of charge to capital acquisitions tax in Ireland. Partnerships are treated as though gifts

[2] The exemption may be lost if the objects are sold within six years after the valuation date.

were made or received by individual partners. The transfer of property into a discretionary or accumulation trust does not give rise to liability to capital acquisitions tax. The payment of tax is not called for until beneficiaries become entitled in possession to any part of the trust property. In the case of life and other limited interests, the value for tax is the underlying property in which the interest subsists. This value is, however, discounted in accordance with actuarial tables which have regard to the age and sex of the beneficiary and the duration of the interest.

34.12 On the basis of our analysis in Chapter 15, we have concluded that the family should be adopted as the unit for all taxes. This means that transfers of wealth within the family, that is between husbands, wives and dependent children, would be tax-free.

34.13 Three questions arise when a child has ceased to be a member of the original family unit, at the age of sixteen years, for the purposes of income aggregation:

(i) How should unrealised gains on property, which the child takes from the original family unit, be taxed?

(ii) How should property transferred from the original unit be taxed to the new unit?

(iii) How should property transferred to the unit for benefit of the child be taxed to the unit?

34.14 We have recommended that the withdrawal of property from the original family unit should be a disposal for capital gains tax purposes. In order to preserve the concept that gifts are part of the tax base as we have defined it, a child, as a new tax unit, must include in his income in the year in which he ceases to be a member of the original family unit, the market value of any property taken with him from the original unit in excess of any lifetime exemption which might apply.

34.15 To avoid the problem of taxing large gifts from outside the family unit to a dependent child, firstly to the family and then to the child when he or she leaves the family, we recommend that a credit be given to the child when he leaves the family unit for any tax paid by the family unit on the gift or bequest.

Relief for Productive Assets

34.16 There is one problem which is common to all forms of capital taxes, whether on transfers of wealth or the holding of wealth. This is the difficulty that may be encountered by the owners of private business or of farms in raising the necessary funds to meet their tax liabilities. The problem

is basically due to imperfections in the capital market which make it difficult for a small company whose shares are not quoted, or for the owner of a farm or of some other unincorporated business, to raise money by sharing the equity in the business with other persons.

34.17 Submissions argued that relief for productive assets was desirable on the grounds that if non-business assets are insufficient to meet death tax liabilities, business may be weighed down by debts incurred to pay taxes or its expansion checked by the desire of the owner to build up liquid assets against future tax liabilities.

34.18 The granting of valuation concessions is only one of a number of possible solutions to this problem. However, this solution is ineffective to the extent that the market reacts to the valuation concession by pushing up the price of assets to which the concession applies. It seems impossible to avoid this price effect for tax purposes unless the assets are exempted completely or taxed on a notional basis unrelated to market value. In either event, the price will tend to rise so that the after-tax return on different forms of investment is equalised. Therefore, the main effect of a concession for productive assets is likely to be a once-for-all capital gain for the existing holders of such assets.

34.19 The use of tax concessions is a much less desirable way of dealing with the problem than measures which make it easier for owners of private business and farms to raise funds to meet tax liabilities without breaking up their businesses. The granting of tax concessions helps everyone, including those who do not require help. It reduces the tax base, thereby making higher rates necessary on the remainder of the base. It relieves a particular class of persons from taxation and it attracts funds simply for tax avoidance purposes into the forms of activity which are favoured.

34.20 We consider that the best solution to the problem of financing the tax liability due on the transfer of illiquid assets is through the use of insurance schemes. For example, it is perfectly possible for owners of businesses to take out insurance policies which will mature at the time they intend to hand over their business (or on death, if earlier).

34.21 If people are not in a position to pay tax in one instalment, then provision should be made for payment of tax by a series of instalments. At present, capital acquisitions tax is due and payable on the valuation date. In the case of a gift, this is normally the date of the gift. In the case of an inheritance, the valuation date is normally the date upon which the inheritance is retained or could have been retained for the benefit of the successor, whichever is the earlier. If tax is not paid within three months of the valuation date then simple interest at the rate of 1.25 per cent per month or part of a month is payable from the valuation date. If the taxpayer so opts,

the tax may be paid in five equal annual instalments. Interest on the entire unpaid tax must be paid with each instalment.

34.22 We consider that the arrangements for payment of tax on gifts and inheritances could be liberalised by extending the period subject to payment of interest at the rate applicable to other taxes. However, we believe that payment of tax in arrears should be made less attractive than insurance schemes.

Assets which are not Readily Realisable

34.23 There is another class of assets which needs to be considered. These assets are those which cannot be readily converted into cash, such as shares in private companies. Aside from problems of valuation for inheritance tax purposes, difficulties might arise for the inheritor in meeting his tax liabilities. These difficulties should be met by allowing payment of tax by instalments in the same way as with productive assets.

Agricultural Land

34.24 Equity demands that it is the amount and not the form of a gift or inheritance which should determine liability to a tax on the transfer of capital. *Prima facie*, efficiency considerations would also support the undesirability of tax concessions, which distort the choice of wealth-owners as to the form in which they hold their wealth. This would suggest that the value of assets for purposes of transfer taxes should be open market value.

34.25 Two main arguments are generally put forward in favour of the proposition that market value is inappropriate in the case of agricultural land and that lower values should be used. These are that

(i) the market price of land is higher than would reflect true agricultural value and so the yield from agricultural assets[3] is lower than that on other assets, and

(ii) there is a danger that tax liabilities could be discharged only by selling part of a farm, thus fragmenting holdings.

34.26 The high price/low yield argument depends for its force on the answers to two questions. Is the yield from agricultural land, in fact, low? If so, is it low because non-farmers are buying land, thereby forcing up its price?

[3]Despite the fact that they are sometimes presented separately, the "high price" and "low yield" are simply different ways of viewing the same phenomenon.

34.27 One of the factors influencing the rate of the annual return on land relative to other assets is that, unlike other assets, land does not depreciate but maintains its real value intact in the long-term. Farmers do not have to provide for depreciation of land. As a result, the gross return on land is equivalent to a net return on other assets.

34.28 The second question is whether the price of land has been forced up by non-farmers. The market in agricultural land is extremely narrow. It has been estimated that about 3½ per cent of the agricultural land in the country changed hands each year in the period 1950-1977.[4] Of total acreage changing hands, 80 per cent passes by gift and inheritance.[5] This suggests that about 0.7 per cent of agricultural land comes on to the market annually and about one-fifth of one per cent of the land is purchased annually by persons with no previous links with the industry.[6]

34.29 One distortion driving up the price of land results from the capitalisation of existing tax concessions. If the pre-tax yields from agricultural land and other assets were equal, special tax concessions for land (or for any other asset) would increase the attractiveness of land as an investment and could be expected to drive up its price.

34.30 Our general conclusion is that the price of land is predominantly determined by existing farmers who should be expected to know what it is worth. The high price argument does not, therefore, support a case for valuing land at less than market value for tax purposes.

Fragmentation

34.31 Two questions require to be answered before introducing concessions on valuations for tax purposes. Firstly, do sales of land actually reduce efficiency? Secondly, could farmers who lack the liquidity to meet tax liabilities generate that liquidity otherwise than by way of sale of part of their holdings? There is no evidence to suggest that farmers who buy land are less efficient than those who sell it. In fact, it might be expected that the opposite is the case. However, there is little doubt that at existing prices, farmers could find it difficult to generate the liquidity to pay gift and inheritance tax at the levels which our general scheme would imply. The question arises whether the imposition of tax at these levels would reduce the price of agricultural land significantly. It is difficult to predict the exact extent to which the price of land would fall. To the extent that it did, the

[4]*The Acquisition and Price of Agricultural Land in Ireland*, P. Kelly. An Foras Taluntais, Proceedings of Conference on the Land Question, 1979.
[5]*New Farm Operators, 1971 to 1975*, NESC Report No. 27 pp 37-38.
[6]NESC Report No. 27 p 52 estimates that in 1971-75, only 30 per cent of land sales were to persons with no immediate connection with agriculture.

accrued capital gains tax losses would provide some element of relief for recent purchasers. In general, we consider that the problem is best solved by charging capital acquisitions tax on agricultural land on the basis of fair market value at existing use. Farmers should be allowed to spread the liability on an annuity basis.

Rate of Tax on Gifts

34.32 As we noted earlier, property transferred during the lifetime of the donor (i.e. as a gift) is charged to tax at 75 per cent of the rate applied to inheritances. We received submissions arguing that further preferential treatment should be accorded to gifts. We also received submissions which questioned the justification for taxing gifts at a lower rate than inheritances.

34.33 Table 38 sets out the statistics that are available in relation to the value of property transferred by way of gift and inheritance which is subject to capital acquisitions tax. These suggest that the proportion of property which is liable to capital acquisitions tax transferred by way of gift is rather small.

TABLE 38

Value of Property Subject to Capital Acquisitions Tax Transferred by Gift or Inheritance

Year	Gifts: Value of Property	% of total	Inheritances: Value of Property	% of total	Total
	£m	%	£m	%	£m
1977	1.2	7.7	14.1	92.3	15.2
1978	1.5	5.0	28.6	95.0	30.1

Source: Annual Reports of Revenue Commissioners.

34.34 It would appear that a lower rate of tax on gifts is a crude instrument for encouraging the transfer of property from older persons to younger persons who might use it more productively. If relief in this area is required it would be more effectively given in the form of relief from stamp duties which apply across the whole range of property values rather than to the largest properties which are subject to gift tax. We also believe that the change which we have recommended in relation to the charging of capital gains tax on death will remove a disincentive to the lifetime transfer of property. In these circumstances, we recommend that gifts be charged to tax at the same rate as inheritances.

Exemption Threshold

34.35 We have concluded that gifts and inheritances should be subject to the single rate of tax which we have recommended should apply to all

income. We see no strong case on equity grounds for any exemption threshold for amounts received by way of gift or inheritance other than that resulting from the tax credits we propose for taxation of other income. However, we recognise that this approach would represent a considerable break with tradition. Despite the fact that it requires a significant breach in our definition of the tax base, some of us see little alternative to providing some threshold below which gifts and inheritances would not bear tax.

34.36 Any threshold selected must be seen in the context of our recommendations regarding capital maintenance which will result in a reduction in the tax charged on capital. Once an individual has obtained any given amount of capital, his income for income tax purposes will be what remains after having maintained intact the value of that capital in real terms. In addition, regard must be had to the fact that transfers between spouses will not bear tax.

34.37. In selecting a threshold it is important to distinguish whether the tax is levied on the donor or the donee. For a family of three children, the same threshold under a donee-based tax will result in considerably less tax being paid than in the case of a donor-based tax such as estate duty. For example, a threshold of £3,000 under a donor-based tax is broadly equivalent to a threshold of £1,000 under a donee-based tax for a family of three children. Under both systems, the amount of property which can be transferred free of tax to these children is identical provided each beneficiary obtains at least enough to benefit from the threshold.

34.38 A further consideration is the relationship of the threshold to average earnings. A threshold enables an individual to acquire a given level of savings tax-free. Equity requires that there should be some relationship between the selection of a threshold and the treatment of individuals who obtain no inheritances or gifts. Any threshold which allows certain individuals to inherit, free of tax, a significant proportion of the likely life-time savings from taxed income of an individual who inherits nothing results in inequities between the two.

34.39 We hold different views on whether or not there should be an exemption threshold for purposes of tax on gifts and inheritances and if so, how much it should be. We are agreed however, that the existing threshold of £150,000 for immediate relatives would be much too high in the context of our recommendations and should be substantially reduced when these are implemented.

Reliefs for Consanguinity

34.40 Capital acquisitions tax is levied on gifts and inheritances at progressive rates which vary according to the consanguinity of the recipient with the donor. The rate of tax on any one gift or inheritance is determined

by reference to the cumulative total received from any one donor or testator. As noted earlier, it is proposed in the Finance Bill, 1982 that all gifts and inheritances received by a beneficiary from all sources within a particular class of donees will in future be aggregated to determine the tax liability on each benefit. The lifetime exemptions and rates of charge for inheritance tax are set out in Table 39.

TABLE 39

Rates of Charge for Inheritance Tax 1981

	Exemption Threshold	Range of Rates		Level at which average rate of tax reaches 25 per cent
		From	To	
	£	%	%	£
Class I: spouse, child or minor child of deceased child	150,000	25	50	450,000
Class II: lineal ancestors or other direct decendants	30,000	5	50	211,750
Class III: brother, sister, nephew or niece	20,000	10	50	124,000
Class IV: others	10,000	20	60	56,667

34.41 The extent of the differentiation in favour of close relatives is quite striking when set against the main argument for progressive gift and inheritance taxes which is that they take better account of the beneficiary's ability to pay. The fact that a son or daughter may inherit almost eight times as much as a complete stranger before the average rate of tax on the inheritance reaches 25 per cent suggests that little account is taken of ability to pay under the capital acquisitions tax code.

34.42 The principle of giving relief on inheritances according to the closeness of the relationship with the deceased is consistent with a civil code which gives members of the immediate family a legal right to a prescribed share of the estate of a deceased member. Such codes in effect declare it to be the general policy of the State that a deceased person's estate should be kept to a great extent within the family. Ireland does not have a civil code, although the spouse and children have certain statutory rights to shares of an estate. However, given these statutory provisions, the question arises whether tax concessions are necessary to complement them.

34.43 One possible justification for relief for inheritances going to family members is that to a stranger in blood an inheritance may be an unexpected windfall, whereas a close relative, particularly a child of the deceased, expects and has a legal right to receive some portion of the estate. Such an argument, if accepted, provides an equal justification for exempting other forms of income from taxation (e.g. wages). Throughout this report we have held that in determining tax liability the only relevant factor is the

receipt of income, not whether it was expected or unexpected, earned or gratuitous.

34.44 On this basis, we conclude that the case in equity for consanguinity reliefs is extremely weak. However, we recognise that this runs counter to the generally held view in Ireland. This provides an instance where logic conflicts with emotion and tradition. We hold divergent views on the question of consanguinity reliefs. However, it is not a major point of principle. We recommend, therefore, that if the case for consanguinity reliefs is conceded, this should be implemented by reducing the exemption threshold in cases in which the relationship is more distant rather than by increasing it for gifts and inheritances passing to children. We are all agreed, however, that the number of classes under the present capital acquisitions tax should be reduced.

Other Matters

34.45 There are a number of other matters of detail which we now consider.

Payment of Tax with Government Securities

34.46 At present, certain Irish Government securities may be accepted at face value in payment of inheritance tax (though not for gift tax) in respect of any property, provided such securities have formed part of that property continuously up to the date of death from the date of the original subscription or for at least three months prior to the death. This arrangement provides a hidden subsidy to the rate of return on Government securities, which would be given more efficiently if the interest rate on these securities were increased. We recommend that the practice be terminated.

Inflation

34.47 We received a number of submissions which suggested that the exemption thresholds for capital acquisition purposes should be index-linked. As we have argued, we see no strong case on equity grounds for any exemption threshold for amounts received by way of gift or inheritance. Nevertheless, some of us consider that a lifetime exemption threshold should apply to all gifts and inheritances and that this threshold should be linked to the Consumer Price Index.

34.48 Once gifts and inheritances are subject to a separate tax which is progressive as a result of an exemption threshold or progressive rates, one further adjustment is necessary to take account of inflation. At present, all taxable gifts and inheritances taken by an individual from a particular donor are aggregated for the purposes of the calculation of tax. The Finance Bill,

1982 proposes that all gifts and inheritances within a particular class should be aggregated. We consider that gifts and inheritances from all sources should be aggregated. We consider also that the value of gifts and inheritances taken in earlier years needs to be inflated to current money values using the multipliers which we have already recommended for indexation of capital gains and averaging.

Small Gifts

34.49 As we noted earlier, the first £500 taken as a gift by a donee from a disponer in any one year to 31 December is exempt from gift tax. Under our proposals small gifts would rank as taxable expenditure of the donor for purposes of direct expenditure tax. On the basis that capital is transferred on average once every thirty years, we consider that annual gifts of up to one-thirtieth of any exemption threshold adopted for purposes of gift and inheritance tax should continue to be exempt from gift tax. This may be justified on a *de minimis* basis to ease administration.

Conclusion

34.50 It may be felt that our proposals for the taxation of gifts and inheritances involve a heavier burden than has been traditional in Ireland. However, the distributional impact of these proposals is likely to be less dramatic than might at first appear. This arises for three reasons. Firstly, transfers between spouses and between parents and dependent children would be completely relieved from tax. Secondly, the nominal rates of tax would be lower than at present. Finally, any increase in tax payable is likely to be mitigated by a fall in asset prices, since these would obviously be worth less than if no tax were payable.

Recommendations

34.51 We make the following recommendations:

1. Gifts and inheritances should be subject to tax at the single rate of tax levied on other income.
2. We hold divergent views on whether or not there should be an exemption threshold for purposes of tax on gifts and inheritances and if so, how much it should be. We are all agreed that the existing threshold of £150,000 for immediate relatives would be much too high in the context of our recommendations and should be substantially reduced when these are implemented. Any threshold should be index-linked.
3. The unit of taxation for the purposes of taxation of gifts and inheritances should be the same as for other taxes, i.e. the family.

4. Children should be charged to tax on whatever capital they take out of the family unit at the time they leave the family unit, subject to the special arrangements outlined in paragraph 34.15.
5. Productive assets should not attract a favourable rate of tax. The problem of financing payment of tax where the amount of liquid assets is relatively low or where the assets are not readily realisable may be dealt with through insurance schemes and liberalising the arrangements for payment of tax by instalments.
6. The basis of valuation of agricultural land should be fair market value at existing use. Farmers should be allowed to spread tax liability on an annuity basis.
7. No general relief should be introduced for assets passing by way of gift rather than inheritance.
8. We hold different views on the question of consanguinity reliefs. If these are conceded, they should be implemented by reducing any exemption threshold in cases in which the relationship is more distant rather than by increasing it for gifts and inheritances passing to children. We are all agreed that the number of classes under the present capital acquisitons tax should be reduced.
9. The practice of accepting certain Irish Government securities at face value in payment of inheritance tax should be discontinued.
10. For the purpose of calculating the amount of tax payable on any particular gift or inheritance, the value of gifts and inheritances received in earlier years should be inflated to current money values.
11. Annual gifts up to an amount of one-thirtieth of any exemption threshold adopted for taxation of gifts and inheritances should be exempt from gift tax but should be treated as taxable expenditure in the hands of the donee.

CHAPTER 35

ANNUAL WEALTH TAX

Introduction

35.1 In this chapter we examine the case for an annual wealth tax. Provided our recommendations for charging income including realised capital gains and gifts and inheritances on a comprehensive basis and for charging dissavings to a direct expenditure tax are implemented, we conclude that the justification for an annual wealth tax on either equity or efficiency grounds is weak. To the extent that the comprehensive tax base does not include gifts and inheritances and realised capital gains, without significant exemptions, the basis on which we reject an annual wealth tax collapses. Subject to a comprehensive tax base being adopted, the main justification for an annual wealth tax is to change the distribution of wealth. In Chapter 36 and Appendix 31 we examine the existing distribution of personal wealth in Ireland and the taxation measures which might be used to change it.

35.2 An annual wealth tax operated in Ireland between 1975 and 1977. The tax was abolished in 1978. The main provisions of the tax are set out in Appendix 30.

Submissions

35.3 We received a significant number of submissions which contended that the yield from the taxation of capital in Ireland should be increased. A number of these favoured an annual wealth or property tax on equity grounds. Others were resolutely opposed to the return of an annual wealth tax on economic grounds. In their discussions of capital taxation, submissions invariably treated taxes on capital gains and transfers of wealth as capital taxes. We have treated these taxes as taxes on income since amounts received in the form of capital gains, gifts or inheritances confer the same potential spending power on the recipient as equivalent amounts of income as this term is normally understood. However, the case for taxes on the holding of capital is inevitably related to the tax treatment of transfers of capital. In the discussion that follows, we focus on the taxation of the stock of capital. In doing so, we assume that all transfers of capital as well as realised capital gains in real terms are taxed at the same rate as ordinary

income, in line with our definition of the tax base. To the extent that this is not done, the analysis must be modified.

The Case for a General Tax on Capital

35.4 The case for an annual wealth tax is usually advanced on the grounds of equity and efficiency. We now consider these arguments.

Equity

35.5 It is held that possession of capital conveys advantages over and above those arising in the form of annual income from it. People who own capital are in a far better position to spend in excess of annual income than those who possess no capital. On this basis, it is held that income tax must be supplemented by a wealth tax.

35.6 If transfers of capital are charged to tax in the hands of the beneficiary at the same rate as ordinary income, his additional spending power from that source is fully taxed. Under our proposals an individual would also have paid income tax on his ordinary income and realised capital gains. Therefore, to the extent that capital was accumulated out of savings, it would have already borne tax. To subject capital to further taxation in these circumstances before it was spent would constitute double taxation and would be inequitable.

35.7 To the extent that transfers of capital are not charged to tax either by virtue of a high tax threshold or by the exemption of a particular class of assets, the case against an annual wealth tax is weakened considerably. A tax on the transfer of inherited wealth as it passes down from parent to child is in effect a periodic charge, levied once in a generation, on the holding of such wealth. In so far as this is the case, it may be regarded as a substitute for an annual tax on capital, but one which is levied once a generation instead of once a year on the holding of wealth. The rate of wealth tax equivalent to a given rate of tax on gifts and inheritances is given by the formula

$$\frac{T}{G}$$

where T is the standard rate of income tax on gifts and inheritances and G is an estimate of the average period in which property is passed from one generation to the next. For example, if the single rate of income tax is 30 per cent and property passes to a new generation on average every thirty years, the appropriate rate of the annual charge would be 1 per cent.

35.8 To the extent that the owners of capital exercise their additional

potential spending power through dissaving, they may come within the scope of the direct expenditure tax which we recommend should apply at the higher levels of expenditure. This is sufficient in our view to meet the requirements of equity arising from the fact that potential spending power is higher for owners of wealth than for those who do not own wealth.

35.9 One of the main problems with imposing a general tax on capital is the difficulty of defining wealth on a satisfactory basis. In principle, all assets to which a value can be attached should be included in the base for a wealth tax. If a particular class of assets is exempted, a taxpayer who owns assets of that class will pay less tax than another taxpayer of equal wealth who owns none, and to that extent horizontal equity as between the two taxpayers will not be achieved.

35.10 While a wealth tax ideally should be comprehensive in scope, there must inevitably be exemptions. It would be impossible in practice to include the value of human capital, which is the present value of a taxpayer's earning power. On administrative grounds, it would also be necessary to exempt personal chattels below a certain figure. However, it would be desirable to include the value of pension rights in the tax base if this were possible. The exemption of pension rights would be totally inequitable between persons employed in occupations with favourable pension arrangements and, for example, self-employed persons who must make provision themselves for their retirement. The difficulty of charging pension rights is a major obstacle to the imposition of an annual wealth tax. It would also be essential to include houses in the tax base.

35.11 The difficulty caused by the need to charge the value of pension rights to wealth tax does not arise in the case of a tax on transfers of capital, since both pension rights and private savings consumed in retirement have no value on death and are not subject to the tax. The difficulty might be reduced if the threshold were sufficiently high so that the number of persons whose future pension rights would have to be valued annually was small. The equity of imposing a wealth tax depends, therefore, on the degree to which the base is comprehensive.

Efficiency

35.12 Because a general tax on capital remains the same on any amount of wealth regardless of the income it yields, it is argued that this gives an incentive to seek out higher yielding assets and may thus lead to a more efficient and productive use of capital resources. This is only partly true. High marginal rates of income tax encourage wealthy individuals to invest in a higher proportion of low-yielding assets than they otherwise would. If a wealth tax which does not vary with the rate of return is imposed and this is associated with a reduction in marginal rates of income tax, there

would tend to be a shift towards investment in higher-yielding assets. However, the main effect of the imposition of a tax on existing capital assets will be a reduction in the price of these assets.

35.13 The main argument put forward against the introduction of an annual wealth tax is on efficiency grounds. Capital taxes may have disincentive effects on saving. Submissions stated that the introduction of a wealth tax in 1975 created a lack of confidence which resulted in a large outflow of funds from the country depriving it of much needed resources.

35.14 To the extent that a wealth tax has disincentive effects, we believe that these are largely psychological. This makes it almost impossible to determine objectively the effect of such a tax on economic activity.

Simplicity

35.15 There are also substantial administrative arguments favouring the taxation of capital transfers rather than the imposition of equivalent taxation annually. If properties change hands on average, say, once every twenty-five years, there will only be 4 per cent as many cases to deal with each year under a transfer tax as under an annual tax on capital. Moreover, on the occasion of a transfer at death valuations of property will normally be necessary for purposes other than assessment to tax so as to carry out a proper distribution of the property between the beneficiaries. Thus, with a transfer tax, there will be many fewer assessments to be made each year and these will be made at a time when properties are to a large extent being valued in any case.

Conclusion

35.16 Provided income including realised capital gains and gifts and inheritances are charged to tax on a comprehensive basis at a single rate and dissavings are charged to a direct expenditure tax at progressive rates, we believe that the case for a general tax on capital is weak. The taxation of capital through the imposition of comprehensive taxation of gifts and inheritances rather than through an annual wealth tax is preferable on grounds of equity and simplicity.

Recommendation

35.17 We make the following recommendation:

1. Provided income including realised capital gains and gifts and inheritances is charged to tax at a single rate on a comprehensive basis and dissavings are charged to a direct expenditure tax, there is no case in equity or efficiency for an annual wealth tax. Accordingly, no such tax should be introduced.

CHAPTER 36

TAXES TO ALTER THE DISTRIBUTION OF WEALTH

Introduction

36.1 In this chapter we consider the tax measures which may be used to change the existing distribution of wealth in Ireland, should it be desired to do so. We conclude that the most effective and efficient taxation instrument in this area is a progressive tax on accessions. This tax would be payable in addition to income tax at the single rate on gifts and inheritances.

The Distribution of Wealth in Ireland

36.2 In Appendix 31 we review the available evidence on the distribution of wealth in Ireland. We conclude that this information is defective and does not provide a satisfactory basis on which to make judgements about the need for capital taxation. The data exaggerate the extent to which wealth in Ireland is concentrated.

36.3 Any judgement about the equity of the distribution of wealth is ultimately purely political. Our views on the matter carry no more weight than others. We would, however, make one observation. There is a presumption on the part of some proponents of capital taxation that, in principle, absolute permanent equality should be the ideal. This does not stand up to analysis. Atkinson[1] has shown that age differences alone can account for a wide range of differences in wealth ownership. In a society in which incomes vary with age and everyone inherits an equal amount of wealth, the top 10 per cent of adults might still own 30 per cent of personal wealth through savings over their lifetime. If this degree of inequality is acceptable, the question arises as to what degree of inequality is unacceptable. If it is further accepted that, for incentive reasons, incomes must be unequal to reward persons of special ability and skill and those who work harder, wider differences in the distribution of wealth will occur.

36.4 All we attempt to do here is set out and examine the means by which

[1] *The Distribution of Wealth and the Individual Life Cycle.*

the distribution of wealth might be altered through taxation measures, if so desired.

Sources of Inequality

36.5 Inequalities in the distribution of wealth arise from differences in savings and amounts received by way of gifts and inheritances or other receipts. There is no direct evidence about the degree of inequality in inherited wealth in Ireland. On the basis of work done in Britain by Harbury, the Royal Commission on the Distribution of Income and Wealth[2] concluded that "on the evidence available the role of inheritance in influencing the distribution of wealth at the top end of the scale is substantial." Harbury showed that of men dying in 1956/57 and 1965 leaving £100,000 or more, nearly 60 per cent had fathers whose estates were valued at £50,000 or more (in 1956/57 prices). If there were no connection between fathers and sons, less than 1 per cent of the population of sons would be expected to have had fathers with this size of fortune. If self-made men are defined as those whose fathers left less than £10,000, they accounted for only about a quarter of those leaving estates of £100,000 or more.

36.6 In a later analysis, Harbury and Hitchens[3] show that when the values of the estates of all relatives (including fathers) were examined, the importance of inheritance for top wealth leavers, as measured by the proportion of predecessors leaving large estates, was nearly three-quarters. As the tally of other relatives was incomplete, this fraction should be treated as a minimum. The authors sum up their findings thus:

> "it is difficult to avoid the conclusion that inheritance has been the most important single source of wealth inequality in the fairly recent past in twentieth century Britain".

36.7 This evidence lends weight to the view that inheritance can be a significant source of inequality in the distribution of wealth. This suggests that a progressive tax on gifts and inheritances is one means of altering the distribution of wealth.

Types of Taxes

36.8 It appears to us that there are three main forms of taxation which could be used to change the distribution of wealth in Ireland. These are a wealth tax or a capital transfer tax based either on the donor or the donee.

[2] First Report, July, 1975 Cmnd 6171 para 272.

[3] *Inheritance and Wealth Inequality in Britain.* C.D. Harbury and D.M.W.N. Hitchens George Allen and Unwin Ltd. 1979 p. 136.

36.9 The wealth tax would apply to present and future accumulations of wealth regardless of source. The capital transfer taxes would apply to gifts and inheritances from a current date. We now examine these three forms of taxation by reference to the criteria of equity, efficiency and simplicity.

Wealth Tax

36.10 To reduce inequality in the distribution of wealth, the most effective form of wealth tax would be one at a level which, when taken together with income tax, the wealthy could only meet by disposing of assets. The logic of this kind of tax would be a heavily progressive wealth tax.

36.11 The main arguments put forward against the introduction of a redistributive wealth tax are on efficiency grounds. To change the distribution of wealth, the top rates of tax would have to be substantially above the 1 per cent embodied in the 1975 Act. If that Act had disincentive effects, one with much higher rates would have substantially more. Whilst we cannot say with certainty what the effect would be on economic activity, it might well lead to dissaving. Unless special concessions were given, it would restrict investment. To give such concessions would have distorting effects. The psychological effects which we referred to in Chapter 35 would inevitably be more pronounced.

36.12 As we noted in Chapter 35, it has been argued that a wealth tax promotes efficiency by encouraging wealth holders to use their assets more productively. We were not impressed by that argument in relation to a modest wealth tax. With a heavy wealth tax aimed at redistribution, such beneficial effects, if any, would be swamped by other economic disadvantages. Furthermore, the inequities arising from incomplete disclosure of assets and, in particular, from the treatment of pension rights and valuation problems are all accentuated if the wealth tax is a heavy one.

Taxes on Transfers of Capital

36.13 We concluded earlier that the transmission of capital by way of gift and inheritance is an important source, though not the only one, of inequality in the distribution of wealth. This raises the issue as to whether or not progressive taxation of transmitted wealth is an appropriate means of reducing inequalities in the distribution of wealth.

36.14 There is no necessary correspondence between the distribution of individual bequests and the distribution of inherited wealth, as inheritors may receive transfers from more than one source. Thus, it is possible that a new large holding of wealth may result from the aggregation of a number of bequests in the hands of a single individual. This highlights one of the

main weaknesses of the capital acquisitions tax as a means of encouraging a more equal distribution of wealth, since up to 1982 it charged tax by reference to the amounts taken by way of gift and inheritance from an individual disponer, all other receipts taken by that beneficiary from any other disponer being ignored. The thresholds, at least in the case of close relatives, are also extremely high.

36.15 In principle, a progressive accessions tax is the most satisfactory way of reducing inequality in the distribution of wealth because it taxes in relation to the total amount of gifts and inheritances received by beneficiaries. It is large receipts (or a large aggregate of gifts) and not large estates that perpetuate inequality. An accessions tax strikes at the heart of the matter by taxing in relation to the cumulative amount received by way of inheritance and gift from whatever source.

36.16 An accessions tax is also more effective in achieving a greater spread of wealth than a donor-based tax on gifts made during life and at death (a modified estate duty). Under the two tax systems producing an equivalent amount of revenue in the aggregate with a progressive scale, more tax will be paid under the accessions tax on estates which are left to a small number of already rich people.

36.17 The National Economic and Social Council has stated on this issue that

> "Where gifts or legacies are split up as between relatives passing on wealth and receiving wealth, there are possibilities for avoiding payment of capital acquisitions tax. Only under an accessions tax, where gifts and inheritances would be aggregated from all sources (and not merely from one donor/testator) could such tax avoidance be prevented. We believe that it would be desirable on all grounds to aggregate gifts and inheritances from all donors/testators in order to produce an all-embracing capital acquisitions tax. In effect, this would transform the acquisitions tax into an accessions tax. We recognise that this might not be administratively possible at this juncture, but we believe that steps should be taken to introduce an accessions tax as soon as feasible".[4]

36.18 The main features of a progressive accessions tax, as we see it, can be summarised as follows:

(i) An accessions tax would be charged at progressive rates on the cumulative total amount of gifts and inheritances received by an individual throughout his life.

---

[4] *Comments on Capital Taxation Proposals*, NESC Report No. 2. 1975, (Prl. 3943), para. 21.

(ii) The rate of tax on any given gift or inheritance would thus be related to the total amount of gifts and inheritances which an individual had previously received.

(iii) The scale of rates would be a "slice" scale, the rate of tax on the first slice being zero, so that no accessions tax would be actually payable until the individual's cumulative total accessions reached into the second slice.

(iv) Accessions tax would be payable in addition to income tax at the single rate on gifts and inheritances; the threshold for accessions tax could in these circumstances be relatively high.

(v) The family would be the tax unit for accessions tax. All transfers between spouses and dependent children would be free of tax.

(vi) There would be no relief for consanguinity.

(vii) The thresholds and brackets of accessions tax would be indexed in line with the Consumer Price Index.

(viii) Accessions in earlier years would, for the purposes of computing the tax payable on any given accession, be inflated by the multipliers which we have already recommended for the purposes of capital gains tax and averaging.

36.19 In contrast with an accessions tax, a donor-based death and gift tax (modified estate duty) is imposed on the gifts made by one person which are cumulated with each other and with the estate left at death in determining the rate of duty deductions, of a deceased person. In general, no regard is had to the interests taken by the beneficiaries, their number or their relationship to the deceased. The rate is progressive according to the size of the entire estate and the amount of gifts made before death.

36.20 The main arguments in favour of a donor-based tax compared with an accessions tax are that

(i) it is simpler and easier to administer, and

(ii) it raises more revenue than an accessions tax.

As against these advantages, it is argued that an accessions tax

(i) is more equitable in that it accords more closely with ability to pay, and

(ii) is better able to reduce inequality in the distribution of wealth.

36.21 We consider that the administrative advantages of a donor-based tax are not significant. With a donor-based tax the Revenue Commissioners are concerned only with the total property and not with the shares and

there are fewer accounts to be dealt with. However, both taxes are mainly imposed at a time when, for purposes of administration, it is necessary to prepare a list of assets of the deceased's estate and to value them. This reduces the compliance costs for taxpayers in that all the information for the calculation of the taxes will be in the hands of the administrator.

36.22 Since these taxes, if they were deemed desirable, would be imposed on top of income tax on gifts and inheritances, the exemption thresholds would need to be fairly high. Because these taxes would therefore be confined to a relatively small number of persons, we are firmly of the view that administrative considerations are not a major issue, especially in Ireland which has already changed from an estate duty (donor-based) to a gift and inheritance tax (donee-based).

36.23 The claim that a donor-based tax yields more revenue than an accessions tax is not wholly valid. It is clear that if an estate duty and gift tax and an accessions tax have the same progressive rate scale, the estate duty will yield more revenue since it applies to the total estate and not just to the shares. To yield a revenue equivalent to that raised under estate duty and gift tax, accessions tax rates need to be set higher. This does not change the overall burden of the tax, but only its distribution. However, there are limits to the rates at which taxes can be levied and as the rate of a donor-based tax approaches these limits, it is probably true to say that it will yield more revenue than an accessions tax.

36.24 The case has been argued[5] that heavy death taxes levied in the form of estate duty or accessions tax reduce inequality in the distribution of wealth, but in different ways. Both may be seen as a means of reducing inequality by transferring a proportion of large fortunes or legacies from wealthy persons to the general taxpayer, thereby reducing inequality in the private sector by reducing the wealth of the richest in particular. Because of its greater revenue potential, an estate duty has greater scope in this area than an inheritance tax. However, an accessions tax is more selective. It is large inheritances rather than large estates which perpetuate inequality. Therefore, a progressive accessions tax, by relating the tax paid to the size of the inheritance, directly tackles inequality resulting from the transmission of wealth between generations by taking a larger slice of estates which are not dispersed. Furthermore, a progressive accessions tax may provide a greater incentive for the dispersal of property amongst persons because this minimises the tax burden.

An Accessions Tax, C.T. Sandford, J.R.M. Willis and D.J. Ironside, Institute for Fiscal Studies, Publication No. 7, September, 1973, Chapters 1 & 2.

36.25 An accessions tax is, in our view, substantially superior in equity terms to a redistributive wealth tax, which we have considered earlier. The main advantage is that it is unnecessary to take account of either the value of human capital or pension rights. An accessions tax would also be more effective than a modified estate duty alone in reducing concentrations of wealth arising from inheritance and in distributing wealth more widely. Under an accessions tax, those who received most wealth by way of gifts and inheritances would be taxed most heavily. Those who received least would be taxed least heavily.

36.26 It is also reasonable to suggest that capital taxes levied on death have less adverse economic consequences for saving and enterprise than other taxes on capital. In some respects, heavy death taxes can bring a positive economic benefit in promoting the mobility of resources and helping to secure their efficient use.

36.27 An accessions tax would be more difficult to administer than a modified estate duty but not, in our view, substantially more so. The feature which makes it more difficult is lifetime cumulation of gifts and inheritances from all sources. Because the threshold for a progressive accessions tax would be relatively high, we do not regard the additional administrative complications as significant.

36.28 The distribution of wealth is a legitimate concern of Government. It is for Government to decide whether intervention to secure a more even distribution of wealth would be in the community interest. Taxation is one instrument which may be used in this area. Should it be decided to use the taxation system in this area, we consider that the most efficient method of doing so is to introduce a progressive tax on accessions. This would be more equitable than other possible tax instruments and is likely to be less disruptive of economic activity.

CHAPTER 37

THE TAXATION OF TRUSTS

Introduction

37.1 In this chapter we consider the present taxation treatment of trusts. We make recommendations for certain changes to ensure that the taxation of trusts is compatible with our general recommendations for the taxation of individuals.

Definition

37.2 A trust may be defined as an obligation which requires one or more persons (the trustees) to hold and deal with property for the benefit of one or more persons (the beneficiaries). Most trusts are established expressly either by a testator by his will or by a settlor by a settlement made by him in his lifetime.

Principles

37.3 In taxing trusts there are only two possibilities. These are to tax the trust itself as a separate entity or to levy tax by reference to the circumstances of the beneficiary as if the trust did not exist. In both cases the tax will have to be paid out of the trust but in the second case the beneficiary's circumstances may determine the rate.

37.4 In line with our approach relating to the taxation of company income, we consider that, while in principle there is no case for a separate tax on trust income, tax should be levied at the level of the trust as a prepayment of beneficiaries' liability. However, credit should be given to the beneficiaries for any tax paid by the trust so as to avoid double taxation of trust income or property. We now consider the treatment of trusts for the purposes of

(i) income tax;

(ii) capital gains tax, and

(iii) taxes on capital and capital transfers.

INCOME TAX

37.5 The general rule is that a trustee is assessed not as a trustee but as a person in receipt of the income, so that the residence of a trust is determined by the country of residence of the trustee. If the trustees reside in more than one country, the country in which the trust is administered is the country of residence. Subject to certain provisions in double taxation agreements, a non-Irish resident trust is liable to Irish income tax at the standard rate on income arising in Ireland.

37.6 A trust or settlement which is revocable by the settlor may result in the income of the trust being directly assessed on the settlor whether or not it is paid out.

37.7 Broadly speaking, trusts fall under three headings for income tax purposes:

Absolute trusts: The trustees hold the income and/or capital for the benefit of specified persons absolutely. Generally, where the income received is paid immediately to the beneficiary, the practice is to look through the trust and tax only the beneficiary.

Contingent trusts: The trustees hold the property for the benefit of one or more persons in fixed shares but contingent upon the occurrence of a specified event, e.g. reaching the age of 25. In this case, the income is regarded for tax purposes as that of the trustees and the trustees are charged to tax at the standard rate. For the purpose of assessment, trustees are not entitled as such to the personal allowances and reliefs that an individual would be entitled to. They are entitled to loss relief for trading or rental losses.

Discretionary trusts: These occur where the trustees hold the property for a class of persons but capital or income may be distributed only at the discretion of the trustees to beneficiaries selected by the trustees who are not bound to distribute to any particular individual beneficiary or beneficiaries. These trusts are charged to tax in the same way as contingent trusts.

Taxation of Beneficiaries

37.8 Where the beneficiaries of an absolute trust are not assessed directly on a "look through" basis, the trustees are assessed in respect of the trust income at the standard rate of tax. The beneficiary is also assessed in respect of his share of the trust income but credit is given against his tax liability for a corresponding proportion of the tax paid by the trustees. In the case of contingent or discretionary trusts, the beneficiary will also be liable to income tax on receipt of income from the trust but he will get a credit for the tax suffered by the trust which is referable to the net income he receives.

Therefore, a distribution of £650 to an individual will mean that that individual will be liable to tax upon £1,000 and, assuming he has a marginal tax rate of 60 per cent, would pay an additional £250 in tax. Undistributed income of a foreign discretionary trust is also chargeable on Irish residents in certain cases.

Deductions

37.9 Generally, expenses payable by trustees under the terms of a trust are only deductible from the trust income of a beneficiary under that trust where the expenses have to be incurred before a beneficiary receives income and where the expenses cannot be for the benefit of the beneficiary. The trustees' expenses and authorised management fees are paid out of the total income of the trust and relief cannot be claimed for these either by the trustees or the beneficiaries. Annual payments made by a beneficiary under the terms of a trust are deductible in computing his total income.

Trusts in Favour of Children

37.10 Generally speaking, trusts set up by a parent for minor children result in the income being taxed on the parent. An exception to this is where a trust created by the parent fulfils the following conditions:

(i) The income is accumulated for the benefit of the child.

(ii) Neither the settlor nor the spouse can benefit from capital or income during the life of the child.

(iii) The trust cannot be revoked, terminated by, or on default of, any person.

Surcharge on Trust Income

37.11 Where income of a discretionary trust is not distributed a surcharge of 20 per cent is imposed. This surcharge does not apply where the trust income is treated for tax purposes as the income of some other person and does not apply to charitable trusts. In addition, it only applies where the income exceeds the properly deductible expenses of the trust and an eighteen month period is allowed for distribution. No additional relief is given for the surcharge when future distributions are made but the beneficiary still remains entitled to a basic tax credit of 35 per cent.

Conclusion

37.12 We consider that the treatment of trusts for income tax purposes is generally satisfactory. Under our proposals for a single rate of income tax, the income of the trust would be charged to tax at the single rate. Full

credit should be allowed to the beneficiary in respect of tax paid by the trustees when the income is distributed to him. When income tax is charged at a single rate, there would be no advantage to be obtained from retaining income in the trust. In these circumstances, the surcharge on the undistributed income of discretionary trusts should be discontinued.

CAPITAL GAINS TAX

37.13 For capital gains tax purposes, there can be a tax impact on

(i) the settlor;

(ii) the trustees;

(iii) the person presently entitled in possession, and

(iv) persons entitled in reversion of contingencies.

Settlor

37.14 Transfers, otherwise than by will, of property by a settlor to a trust are taxable on any gain by reference to the value of the property at the time of the transfer, even if the trust can be revoked and even if the settlor has some interests in the trust as a beneficiary. If a loss arises on the transfer, it can be offset against capital gains arising on disposals by the settlor within the same year of assessment. If the gains in that year are sufficient to absorb the loss fully, any balance can be carried forward and offset against future gains of the settlor.

37.15 We consider that a transfer of property by a settlor to a trust should remain a disposal for capital gains tax purposes. Losses realised in these circumstances should not be restricted and should be allowed fully against other income.

Trustees

37.16 Trustees are a continuing body of persons and changes in trustees do not constitute a disposal for capital gains tax purposes. We think this is right.

37.17 The holding of property in a trust can give rise to a capital gain between the time the property is taken into the trust and transferred or appointed by the trustees to a beneficiary. Such transfers or appointments are taken to be at market value and are treated as disposals for capital gains tax purposes. Similarly, where a beneficiary becomes absolutely entitled to his trust property the trustees are treated to have disposed of the property to the beneficiary at market value, this will give rise to a tax charge upon the trust. From then on the trust is ignored for capital gains tax purposes,

as the beneficiary is treated as having acquired the assets. We consider that this treatment is satisfactory.

37.18 If a person becomes absolutely entitled to trust property by reason of the death of a person with a life interest, the trustees are treated as having sold and reacquired the property at that date but no chargeable gain accrues and the re-acquisition is deemed to be at market value at date of death. Our proposal to treat death at a disposal for capital gains tax purposes requires that any chargeable gain arising in these circumstances be charged to tax.

CAPITAL ACQUISITIONS TAX

37.19 Capital acquisitions tax arises where people become beneficially entitled in possession to a gift or inheritance. Since the objects of a discretionary trust are not beneficially entitled in possession, no capital acquisitions tax arises on a transfer to such a trust. Property appointed to a beneficiary by trustees under a discretionary trust is treated as if it had come from the original settlor to the beneficiary and taxed accordingly. In the case of other trusts, the tax treatment of the beneficiaries varies according to the nature of the trust.

Trusts Other than Discretionary Trusts

37.20 Where property is vested in the trustees for the benefit of a specified beneficiary and the beneficiary has an immediate right to be put into actual possession, immediate liability to capital acquisitions tax arises on the part of the beneficiary. The trustees may, however, be liable to discharge any tax liability. The capital acquisitions tax is charged on the basis that the settlor donated the assets directly to the beneficiary. We recommend no change in these arrangements.

37.21 Where a property is vested in trustees for a specified person for a period, e.g. life, and thereafter for a remainderman, capital acquisitions tax will be charged on both the person receiving the life or limited interest and the remainderman when each of them becomes entitled in possession. We recommend no change in these arrangements.

Discretionary Trusts

37.22 As noted in paragraph 37.19, liability for capital acquisitions tax does not arise on transfer to a discretionary trust and is only charged when a beneficiary becomes entitled in possession on a distribution or appointment by the trustees. Accordingly, such trusts can be used to defer the charge to capital acquisitions tax until the beneficiary becomes beneficially entitled in possession.

37.23 An annual tax on capital is equivalent to a periodic charge on gifts and inheritances. Since discretionary trusts can be used to defer indefinitely the charge to capital acquisitions tax, we recommend that tax should be charged on the market value of property transferred into a discretionary trust and annually thereafter. In present circumstances, a rate of tax of the order of 1 per cent would be appropriate. We do not recommend any exemption threshold for this charge because to do so would give rise to tax avoidance. Any transfers out of a discretionary trust should continue to give rise to tax in the hands of the beneficiary. The charge to tax should be based on the property transferred together with the amount of the tax credit proposed in paragraph 37.24.

37.24 Provided the property is transferred out of a discretionary trust within thirty years (the value of G in the formula given below[1]), any tax paid on the property in the discretionary trust should be allowed as a credit against the liability of the beneficiary to gift and inheritance tax. Credits should be in proportion to the capital paid out of the trust. Transfers of property out of the trust could be deemed to be on a first in first out basis. Under this scheme, the tax paid by the discretionary trust would be regarded as an advance payment of gift and inheritance tax. Once a period of thirty years elapsed since the property was transferred into the trust, it would have to be assumed that a generation had been skipped and the credit would be lost. However, tax paid in the second thirty year period would be available as a credit and so on. The credits should be indexed and refundable if the ultimate liability was less than the tax finally found to be due.

Recommendations

37.25 We make the following recommendations:

1. Trusts should be charged to income tax at the single rate.
2. Full credit should be allowed to the beneficiary for any income tax paid at the trust level when the income is distributed.
3. When income tax is charged at a single rate, the surcharge on the undistributed income of trusts should be discontinued.
4. The transfer of property by a settlor to a trust should remain a disposal for capital gains tax purposes. However, restrictions on the allowability of losses in the circumstances should be removed.
5. The death of a person with a life interest in any property should be treated as a disposal for purposes of capital gains tax.
6. Tax should be charged on the market value of property transferred into a discretionary trust and annually thereafter. This tax would be an advance payment of capital acquisitions tax. The rate of tax should be of the order of one per cent. There should be no exemption threshold. Provided the property is transferred out of a discretionary trust within thirty years, any tax paid on the property in the trust should be allowed as a credit against the liability of the beneficiary to gift and inheritance tax. The credit should be indexed and refundable. Once a period of thirty years had elapsed, the credit accumulated over that period would be lost.

[1]The rate of the annual charge equivalent to a given rate of tax on gifts and inheritances is given by the formula

$$\frac{T}{G}$$

where T is the rate of tax on gifts and inheritances and G is an estimate of the average period in which property is passed from one generation to the next.

Part III

Implementation of Proposals

CHAPTER 38

IMPLEMENTATION

Introduction

38.1 In this chapter we outline our views as to how our proposals for the reform of direct taxation could be implemented. The present tax system is inequitable and complicated. It distorts economic decisions in many ways. However, if a proper system of taxation were introduced overnight, the reduction in the incomes of certain taxpayers who enjoy favourable treatment under the existing system could be severe. Fairness and practicality require an appropriate degree of phasing.

38.2 The transition from the old to the new system will cause some organisational disruption. The accountancy and legal professions and the Revenue Commissioners and their staffs will require time to adjust to the new system. So will business and enterprise generally.

38.3 We see the transition falling into three phases which may overlap:

(i) Phase one involves those items on which work can begin immediately.

(ii) Phase two covers items which cause greater difficulty.

(iii) Phase three deals with the steps involved in the final integration of the system of direct taxation.

The Single Rate of Income Tax

38.4 A major feature of our proposals is that all income including realised capital gains and taxable gifts and inheritances should be charged to tax at a single rate. This has great advantages. It allows the tax system to be neutral between income and realised capital gains and between income accruing to companies and to individuals. It provides for considerable simplification of the tax system and reduces the scope for tax avoidance substantially. It facilitates a significant widening of the tax base. We believe that the single rate of income tax should be as low as possible.[1] Accordingly,

[1] In the remainder of this chapter we assume for illustrative purposes that the single rate of income tax (excluding social security tax) will be 25 per cent.

in the transition to a single rate of income tax, we recommend that those items of income which are at present excluded from the income tax base and which cannot immediately be charged as income should be charged to tax at a rate of 30 per cent. This rate is designed to take account of the fact that such items of income will not be charged to tax at progressive rates in the transition phase, during which time there will be no progressive taxation of consumption.

Interlocking Recommendations

38.5 Some of our recommendations are so inextricably linked that it is imperative that they should be implemented together. We have identified these linkages in so far as this is possible.

PHASE ONE

38.6 Tax reform in phase one involves action under a number of headings:

(i) Extension of the income tax base.

(ii) Charge to tax of lump sum receipts and other windfalls.

(iii) Reform of income tax structure

(iv) Reduction in income tax rates.

(v) Reform of capital gains tax.

(vi) Reform of corporation tax.

(vii) Reform of capital acquisitions tax.

(viii) The adjustment of taxes for inflation.

(ix) Reform of social insurance contributions.

Extension of the Income Tax Base

38.7 The existing income tax base is too narrow. Progress in extending the base can and should be made immediately. Among the items which can be tackled at once are the following:

(i) The taxation of short-term social welfare benefits.

(ii) The charging to tax of foreign pensions.

(iii) The repeal of artists' exemption.

(iv) The repeal of the tax exemption on profits of certain sweepstakes.

(v) The repeal of relief in respect of expenditure on residential premises.

(vi) The abolition of medical insurance relief.

(vii) The abolition of relief in respect of premiums paid under permanent health insurance schemes.

(viii) The withdrawal of tax relief for new convenants.

(ix) The repeal of the 20 per cent relief for individual investors in certain industrial companies.

(x) The withdrawal of relief in respect of life assurance premiums.

(xi) The securing of realistic assessments in respect of fringe benefits.

38.8 The proper taxation of fringe benefits relates mainly to cars and preferential loans, which are the benefits most widely available to employees. When the benefits from cars are charged to tax in a satisfactory way, the restriction on the capital allowances and running expenses of certain motor cars should be dispensed with.

Lump Sum Receipts and Other Windfalls

38.9 Lump sum receipts and windfalls confer the same command over economic resources as other income and should in principle be charged to tax in the same way. In the absence of proper averaging provisions, it would be unfair to subject such receipts to the full scale of progressive rates, since they typically accrue in an uneven pattern. However, this does not justify their complete exemption from tax. Accordingly, we recommend that in phase one of the transition such receipts should be charged to tax at a single rate of 30 per cent. If it would be more advantageous to the taxpayer, such receipts should be charged as income in the year of receipt. The items of income which we recommend should be treated in this way are:

(i) Compensation payments for loss of office.

(ii) Lump sum retirement benefits.

(iii) Lump sum payments under the Redundancy Payments Act, 1967.

(iv) The element of compensation payments for physical or other injury attributable to loss of past or potential future income.

(v) Prize bond prizes and sweepstake winnings.

(vi) Net gambling winnings.

Reform of Personal Income Tax Structure

38.10 We have recommended substantial reform of the personal income tax structure. Among the items which we think should be implemented in phase one are:

(i) The adoption of the family as the unit of personal taxation.

(ii) The replacement of income tax allowances by tax credits.

(iii) The repeal of general exemption limits.

(iv) The replacement of the income tax child allowance and the social welfare child allowance with a universal child benefit.

(v) The abolition of many secondary allowances and their replacement, where necessary, by direct payments.

Reduction in Income Tax Rates

38.11 The effect of the measures outlined above would be to increase the progressivity of the tax system at existing rates of income tax. These measures should be offset to a greater or lesser degree by a reduction in the nominal rates of income tax and a widening of the rate bands. For example, if these measures are implemented, we believe that the maximum marginal rate of income tax should not exceed 50 per cent.

38.12 There are great advantages in having the vast majority of taxpayers liable at a single marginal rate. This enables schemes for deduction of tax at source to work most effectively, thereby improving the efficiency of tax administration and reducing tax evasion. We believe that progress should be made in phase one towards integrating the reduced and standard rates of income tax into a single band of taxable income. We have shown in Chapter 17 that the abolition of the reduced rate could be achieved without cost to the Exchequer and on a basis which would favour low income taxpayers, provided appropriate adjustments were made in income tax rates or credits.

38.13 At the end of phase one, income tax would be levied on a wider base at lower rates, with the vast majority of taxpayers liable at a single rate of tax.

Reform of Capital Gains Tax

38.14 It is also necessary to widen the base for capital gains tax. This requires extending the range of chargeable assets, particularly principal private residences, abolishing many of the existing reliefs and treating death as a disposal. The abolition of roll-over relief should be linked with the allowance of real losses for capital gains tax purposes. The exemption of small gains also should be repealed.

38.15 In the transitional period, capital gains arising to individuals should be charged at a single rate. This rate should be between 25 per cent and the existing maximum marginal rate of personal taxation. As the maximum rate of income tax is reduced, the rate of tax on capital gains should be

correspondingly adjusted. The actual rate should be selected so as to achieve neutrality in the treatment of income and realised capital gains to the greatest extent possible.

Reform of Corporation Tax

38.16 We have outlined our objective of treating income accruing to companies in the same manner as other income. To do otherwise distorts economic decisions, is unfair and leads to tax avoidance. Substantial reform of corporation tax is possible in phase one of the transition. The measures we have in mind are the following:

(i) A withholding tax on distributions should be introduced. This should be accompanied by an increase in the rate of imputation on distributions, ultimately leading to full imputation.

(ii) The special rate of tax applying to small companies should be abolished.

(iii) Close companies should be charged to tax on a partnership basis. In these circumstances, the surcharge on the undistributed income of certain close companies should be abolished.

(iv) Income arising in the form of capital gains in companies should be charged to tax at the same rate as other company income.

(v) The rate of corporation tax should be reduced in line with the rates of income tax.

38.17 The objective behind these measures is to eliminate existing distortions and achieve the greatest possible degree of neutrality between company income and that coming from other sources.

Reform of Capital Acquisitions Tax

38.18 The existing capital acquisitions tax is characterised by very high nominal rates of charge on a base which is eroded through the granting of exemptions and reliefs and relatively high thresholds. Our proposals involve a reduction in the rates of tax and a widening of the base. The immediate measures we have in mind are as follows:

(i) The family should be adopted as the unit of taxation. As a first step towards this all transfers between spouses should be exempt;

(ii) All gifts and inheritances received by a beneficiary from all sources should be aggregated to determine tax liability on each benefit;

(iii) The rates of tax, particularly the higher marginal rates of tax, should be reduced. We consider that the maximum effective rate of tax on a gift or inheritance should be between 25 per cent and

the existing maximum marginal rate of personal taxation. As the maximum rate of income tax is reduced, the maximum marginal rates of tax on gifts and inheritances should be correspondingly adjusted.

(iv) Relief for productive assets should be discontinued and replaced by the adoption of fair market value at existing use for purposes of the tax.

(v) The tax thresholds for the immediate family should be reduced somewhat given the fact that transfers between spouses would be exempt.

The Adjustment of Taxes for Inflation

38.19 We have detailed the distorting effects of inflation on taxation in Chapter 7. It changes the overall level of taxation as a proportion of national income. It raises the share of particular taxes as a proportion of total tax revenue and reduces others. It changes the distribution of taxation among individuals in an arbitrary fashion; it favours those who can arrange to pay their tax later and it distorts the tax base. For these reasons, it is essential that measures are taken very soon to adjust the tax system for the effects of inflation. The steps we have in mind are as follows:

(i) All Schedule D taxpayers should be brought to a current basis of assessment. When this has been achieved the additional allowance for Schedule E taxpayers should be discontinued.

(ii) The personal tax structure should be indexed. This also involves indexing losses and capital allowances carried forwards or backwards.

(iii) The cost of sales adjustment should be extended to all business sectors.

(iv) The restrictions on the proportions of income which may be devoted to the purchase of retirement annuities by self-employed persons should be relaxed.

(v) As a first step towards taking account of real interest income, the exemption limit for bank deposit interest should be increased very substantially and the treatment of interest on deposits with various financial institutions should be aligned.

(vi) The deduction for interest paid in full should be withdrawn.

(vii) All new Government securities should be treated as chargeable assets for capital gains tax purposes.

Reform of Social Insurance Contributions

38.20 We have proposed that social insurance contributions be replaced by a social security tax levied at a uniform rate on all income including realised capital gains and taxable gifts and inheritances. Early progress towards this end can be made under a number of headings:

(i) Health contributions and the youth employment levy should be discontinued.

(ii) Income tax credits should be allowed against liability to employees' social insurance contributions.

(iii) A single rate of social security tax should be levied on all income, including realised capital gains, gifts and inheritances.

(iv) The employers' social insurance contribution should be phased out and replaced by the contribution at the employees' rate on the income of self-employed individuals and income which arises in the first place to companies.

PHASE TWO

38.21 At the end of phase one, the present system of direct taxation will be considerably improved. However, many of the existing inequities and distortions will remain, albeit at a reduced level. The task during phase two is to move closer to the complete integration of direct taxation. Such a move is dependent on the introduction of a system of income averaging as outlined in Chapter 19.

38.22 It is desirable that averaging be introduced as soon as possible and extended to all taxpayers. We recognise that this may not be easy. However, the need for averaging over a relatively long period is urgent and steps should be taken immediately to ensure that it can be introduced without undue delay.

38.23 Once averaging has been introduced, all items of ordinary income and realised capital gains, which accrue over a period less than the averaging period, should be charged to progressive rates of income tax.

38.24 During this phase progress should continue to be made on items started in phase one. In particular, the move to reform the employers' social insurance contributions should continue until a charge is levied on company income and taxable gifts and inheritances at the same rate as ordinary income. Progress should also be made towards ensuring that only real interest, paid or received, is taken account of for income tax purposes.

PHASE THREE

38.25 This phase represents the complete integration of the system of

direct taxation. The major elements in this phase are the achievement of a single rate of tax on all income including realised capital gains, income arising to companies and taxable gifts and inheritances and the introduction of a direct expenditure tax at progressive rates to replace the higher rates of income tax.

Direct Expenditure Tax

38.26 We now consider the transitional problems which may arise in the introduction of a direct expenditure tax and the arrangements which are needed to overcome them.

38.27 One of the problems with changing to a direct expenditure tax is that of equity. The Department of Finance and the Revenue Commissioners put the issue succinctly in their memorandum to us on the question of an expenditure tax:

> "The solutions so far put forward for dealing with the transitional difficulties merely mask the real problem which derives from the inequity of taxing dissavings under an expenditure tax when the resources involved have been built up out of savings from income previously subjected to progressive income tax".

38.28 Some people would be worse off as a result of a change from progressive income tax to direct expenditure tax. This is because savings made before the changeover and spent afterwards would (unless special relief were given) be taxed twice. Any savings made with the purpose of financing large items of consumption expenditure would suffer. To the extent that these savings had obtained relief from income tax, this problem would be diminished. On the other hand, some people would be better off. This could arise where consumer expenditure had been incurred before the changeover and financed by a loan which was repaid after it.

38.29 We consider that the equity problems in making a transition to direct expenditure tax are exaggerated. If undue weight is given to them, no change can ever be made in any tax system. For example, the arguments advanced in paragraph 38.27 could be taken to preclude any shift from direct to indirect taxation. In considering the transitional effects of changes in tax legislation, it must be borne in mind that all changes affect some persons favourably and others unfavourably. We believe that unless these effects are significant there is no need on grounds of equity for special transitional measures.

38.30 The amount of dissavings subject to any element of double taxation under the proposals for a direct expenditure tax will be small. This is because it will only be annual expenditure above the exemption level which

will be subject to the new tax charge and the amount of that charge will correspond to the excess of the present higher rates of tax over the standard rate of tax. At present, this excess amounts to 10 per cent, 20 per cent and 25 per cent. Much of the accumulated savings will have been made free of tax and an additional amount will have borne tax at the standard rate only. For example, contributions to approved pension funds are tax-free and savings accumulated in the form of capital gains will not have been subjected to the full impact of progressive income tax rates. In these circumstances, we consider that relief could be denied for those who have accumulated savings before the introduction of direct expenditure tax. However, we consider that relief should be given because this will ease the transitional problems.

38.31 Before the date of transition there could be a steady running down of investments in listed assets (e.g. bank and building society deposits). The object would be to start off under the direct expenditure tax with the minimum amount invested in listed assets. This could cause problems in the capital market.

38.32 These problems would be mitigated if inflation were at relatively high rates at the time of transition, thereby making the holding of cash expensive. The problems would be further reduced if the rates of direct expenditure tax were relatively low. The continuation of a tax on capital gains would also reduce the problems somewhat.

38.33 The most effective method of dealing with tax avoidance would be to require a registration of initial net worth based on a detailed return of net worth at the date of publication of this report. This would allow cases of avoidance to be monitored and anti-avoidance provisions could be introduced, if necessary.

Relief for Savings Made Before the Transition

38.34 If it were decided that relief should be given to avoid the double taxation of savings made before the transition to a direct expenditure tax, it would be possible to do so. The objective would be to allow the consumption of accumulated savings without incurring tax liability and disallowing repayments of existing loans for qualifying for an expenditure tax credit. Such an approach could also have advantages in preventing tax avoidance and avoiding changes in consumption patterns solely for tax reasons.

38.35 There are three possible methods of giving relief for accumulated savings.[2] All three methods involve a registration of initial net worth based

[2] *Progressive Expenditure Tax — an alternative?* Sven-Olof Lodin, p. 123.

on a detailed return. The concealment of savings would be of minor significance since it is immaterial whether a deduction for savings is obtained at the transition or later. There would be no reason for a taxpayer to conceal property in order to obtain a savings deduction later on.

38.36 The verification of a taxpayer's indebtedness would be even less important. If this item were under-reported, the taxpayer would have to continue this under-reporting when the tax came into operation, for if the amount reported were increased, the increase in the amount of declared indebtedness would be registered as new borrowing and would attract liability to tax. However, if part of the indebtedness continued to be concealed, there could be no gains to the taxpayer as amounts applied to the repayment of the debts in question would not be deductible.

38.37 The neutrality in the transitional phase, both on the assets and liabilities side, would mean that neither tax gains nor tax losses could be made by arranging for consumption to be brought forward before the date of introduction of the direct expenditure tax. The question to be answered in determining liability would be whether or not the consumption was financed from income earned before the introduction of direct expenditure tax. Thus, the transitional rules would not lead either to a rush to consume or to increase savings before the introduction of the new system. Nor would there be any reason for a taxpayer to increase cash holdings.

38.38 The problem of arranging for existing savings to be free of tax if consumed and ensuring that the repayment of existing loans would not qualify for a tax credit could be tackled, as previously mentioned, by any one of three methods. These are the total assets method, the net assets method and the credit method.

The Total Assets Method

38.39 Under this method the taxpayer's total assets and total liabilities are established. So long as gross savings remain above the initial level, all new saving and dissaving are taken into account in determining tax liability. The same applies to all new borrowing and loan repayments so long as the aggregate indebtedness does not fall below the initial level. On the other hand, the consumption of savings existing at the time of the changeover would not involve liability to tax. The repayments of existing debts would not carry a right of deduction.

38.40 Under this method, the problems of control are minimised as it is only an overstatement of the asset side of the account which can yield a tax advantage. However, it would be difficult to achieve this, since any overstatement could give rise to a re-opening of income tax liability for earlier years.

The Net Assets Method

38.41 Under this method, the taxpayer's net assets would be established at the time of the changeover. If net assets were to fall below the initial level, then consumption would not attract tax liability. Other changes in net assets would be taken into account.

38.42 If the taxpayer had net liabilities at the outset, he would not obtain a credit when subsequently his net assets increased or his net indebtedness diminished. So long as net liabilities remained above the initial level, or the level when non-deductible repayments had been made, all changes in net assets would be treated in accordance with the new rules.

The Credit Method

38.43 Another transitional method which would allow a direct expenditure tax to be introduced with immediate effect would be through the credit method. If the taxpayer had net savings, he would be given a tax credit obtained by applying an average rate of tax to the amount of savings. He could use this credit subsequently by setting it off against expenditure tax liability incurred later as a result of dissaving. Conversely, in the case of net indebtedness, the taxpayer would be debited with a tax liability which would be set off against future savings or repayments of debts. This method, which is similar to the net assets method, has the advantage that the transitional period required is shorter than with either of the other methods.

Conclusion

38.44 None of the transitional methods outlined above need to be used after a person's death. This is because in assessing the taxation of heirs there is no need to take account of the extent to which the deceased had taxed savings or untaxed loans. In other cases some form of time limit would be desirable. In general, we favour as short a transitional period as possible.

38.45 It is, of course, possible to introduce a direct expenditure tax without any relief for taxed savings and untaxed loans. In this case, all forms of consumption after the introduction of the new tax would be treated equally. We do not think that such an approach causes unacceptable problems of equity between taxpayers. We believe that the transitional method selected should be the one which offers the fewest administrative problems, provides the greatest protection against avoidance and the least possible disruption to economic life.

The New System

38.46 Once the direct expenditure tax has been introduced, the new system which we recommend would be fully in place. All income, realised capital gains, company income and taxable gifts and inheritances would be charged at a single rate of tax. This would be the rate at which the vast majority of taxpayers would be liable. We believe that this system would be simpler and more equitable than the existing system. It would also eliminate the distortions in our economic life which the present system causes. It would favour the accumulation of capital for productive use and substantially change the balance of the tax system in favour of savings. Such a system is also capable of producing the revenue which is generated by the existing system of direct taxation. However, under the new system the rates of tax would be lower and the base wider. We believe that it meets the requirements set down in our terms of reference.

Miriam Hederman O'Brien (Chairman)
Donal Carrol
Derek Chambers
James Gallagher
Camilla Hannon
Daniel Murphy*
Donal Murphy*
Donal Nevin*
Patrick P. O'Neill*
Raymond O'Neill*
W. J. Louden Ryan

Donal de Buitléir
Secretary
18 June, 1982

*Subject to Reservations—see pages 310, 311, 390 and 469—484.

OBSERVATIONS AND RESERVATIONS

by

MR. DANIEL MURPHY AND MR. DONAL NEVIN

1. The Trade Union Movement in its campaign for a reform of the taxation system has concentrated above all else on the need for greater equity so that all sections pay their fair share of the taxes required to provide public services to the community and to support the needy and the deprived and all those requiring help through the State.

Equity

2. In our approach to the proposals of the Commission we have been mainly concerned with the equity aspects. Equity is partly a matter of subjective judgement and does not lend itself to wholly scientific evaluation. For our part, we are satisfied that the overall system of direct taxation which the Commission has recommended would be far more equitable and fair in its incidence than the present system.

3. For the purpose of its proposals, the Commission defines income in the broadest sense as including not only earnings but any accruals that add to a person's economic resources. It, therefore, would tax as income major elements of capital accessions that at present are virtually free of tax. The proposals ensure that the incomes — so defined — of all sections, whether employees or self-employed, would be taxed on the same basis.

4. Under the tax structure proposed, many tax allowances which have had regressive effects since they accrued principally to the benefit of the higher income groups would be eliminated.

5. In both these respects, the proposed structure would increase significantly the equity of the tax system. It would also make for far greater simplicity in the tax code.

Tax Rate

6. Because of the broader definition of income and the widening of the base, the rate of direct taxation required would be lower than under the present system and this reduction would be achieved without any transfer from direct to indirect taxes.

7. It should be noted also that the proposed system would result in far less evasion of tax and less tax avoidance, thus eliminating some of the more pernicious features of the existing tax system. This too would contribute to a lower rate of tax.

Progressivity

8. Progressivity is essential to an equitable tax system. Under the Commission's proposals, the degree of progressivity will be partly determined by the combination of the personal tax credits and the rate of tax. These will be basically matters for political decision. However, a major proposal by the Commission that would result in a progressive tax system is the introduction of a direct expenditure tax that would be levied on the personal consumption expenditure of those at the higher end of the income/wealth scale. Such a tax would be levied at progressive rates.

Total Tax Structure

9. We wish to stress that our support for the Commission's proposals depends on the acceptance of the total tax structure that is recommended. We would, of course, be opposed to the selective application of some of the recommendations only. Indeed, we would reject certain of the recommendations if they were to be applied in isolation. The system proposed by the Commission must be seen as a whole. In particular, the achievement of equity depends on the entire set of proposals being implemented since it is the sum of the changes suggested that would result in an equitable tax system.

10. It is also necessary for us to point out that the present report does not deal with a number of important aspects of the tax system such as the use of the system to provide incentives for economic development, administration, etc.

11. There are certain aspects of the Commission's proposals on which we have some reservations, or on which we wish to make observations.

Tax Expenditures

12. Over the years concessions designed to encourage particular activities and to give special reliefs have accumulated. These have been to the benefit of many but at the cost of eroding the equity of the entire system, apart from the complications thereby introduced. The proliferation of tax expenditures (exemptions or reliefs) has had the effect of narrowing the tax base and in consequence, higher rates of tax than would otherwise be required. For these reasons we have accepted that it is desirable, in principle, to switch from the use of tax expenditures to direct public expenditure.

Exemptions

13. Because of the broad definition of income adopted by the Commission, there can be no rational argument for special treatment, for tax

purposes, of any particular category of income however desirable this might be socially or however small the amount of income involved. Exemptions tend to breed exemptions. For these reasons we have accepted the conclusion that the exemption from tax of certain social welfare benefits is contrary to equity principles which dictate that it is the amount of income rather than its source that should determine whether tax is payable. We would assume, however, that the level of tax credits that would operate under the proposed system would be such as to exclude most persons dependent on social welfare payments.

Fringe Benefits

14. We have accepted that the ending of tax expenditures (reliefs/allowances) which have been of particular benefit to persons in the higher income groups is an essential element both for the widening of the tax base (which is necessary if the rate of tax is to be reduced) and the achievement of greater tax equity. The same arguments apply to the treatment of fringe benefits (benefits-in-kind) of whatever kind which the Commission propose should be treated as income. In our view, there can be no point in wishing the end (tax equity) unless we will the means (the ending of special treatment for certain types of income, benefit-in-kind, or income substitutes).

Personal Tax Credits

15. The Commission is recommending that any tax reliefs which remain in the direct tax system should be given in the form of tax credits in place of tax allowances. The indexation of personal tax allowances has been a constant demand of trade unions. The Commission has concluded that the tax system should be neutral in relation to inflation and in consequence has recommended that personal allowances/credits should be adjusted in line with changes in the Consumer Price Index.

Redistribution

16. The Commission recommends that income tax should be levied at a single rate but this rate would be levied on a much wider income base. A comprehensive tax base is at the heart of the case for progression in tax rates but this has been frustrated in the past. As the Commission's report established, the income tax system has been clearly inadequate as an instrument of redistribution. In a recent year the actual income in tax assessments amounted to only 50 per cent of personal income. Far from redistributing resources effectively, income tax has been a tax on earnings. Hence, the Commission's proposals require that redistribution be achieved by other means.

Direct Expenditure Tax

17. The main recommendation of the Commission that tax be charged at a single rate on income, realised capital gains, gifts and inheritances, in itself would not involve any degree of progressivity which is also necessary to achieve equity. Essentially what has been recommended by the Commission is a sur-tax on expenditure at progressive rates to apply to individuals with relatively high expenditure. The direct expenditure tax would ensure the desired degree of progressivity at the top end of the scale.

18. We regard the introduction of such a direct expenditure tax as a far-reaching and progressive addition to the tax system. We have had some hesitation as regards its practicality and at the fact that such a tax has not as yet been introduced elsewhere (though the Swedish Commission on Taxation has recommended a sur-tax on expenditure).

19. A direct expenditure tax would be considerably more difficult to avoid than an income tax charged at a high rate. In practical terms it would be an important anti-evasion measure. The Commission considered that the scope for tax avoidance under a system in which all accretions would be taxed at a single rate and expenditure subject to a progressive direct expenditure tax is negligible compared with that which exists under a progressive income tax with separate taxes on capital gains, gifts and inheritances.

20. The expenditure threshold for payment of direct expenditure tax and the degree of progressivity in the rate structure are matters for decision by Government. The threshold will determine the number of persons likely to be covered. (In 1981/82, about 17 per cent of all income taxpayers were liable to tax at rates higher than the standard rate. The net produce of tax at the higher rates amounted to £106 million or 3 per cent of total tax revenue).

Corporation Tax

21. The Commission argues strongly the desirability of a single rate of tax for all income including corporate profits. We must, however, reserve our position on this matter. We would certainly not exclude the possibility of imposing a sur-tax on corporate profits especially where the profits are made in monopoly situations, or are in the nature of windfall profits, or the result of speculation, or in other circumstances as the Government might determine as appropriate.

Social Security and Employers

22. We reject the Commission's proposal that employers' contribution to the Social Security Fund should be limited to the amount appropriate to the specified social security tax on their income. We consider that a payroll tax

is an appropriate means of helping to finance social security as is the case in most countries. The amount of such a tax would be a matter for political decision in the light of the economic circumstances and the needs of the Social Security Fund.

Negative Income Tax

23. On balance we accept the Commission's conclusions on the question of negative income tax schemes, in particular that the most effective and efficient way of helping the poor is to ensure that they have an adequate income, this being done through the social welfare system. The Commission's approach, involving the continued separation of direct tax and income maintenance schemes, meets the objectives of negative income tax schemes better.

Farmers' Income

24. The Commission's recommendation that all farmers should be subject to income tax and be charged to tax on the basis of their actual profits is, we consider, a major step towards a more equitable tax system. While it considered that there was no justification on equity grounds for imposing a resource tax, the Commission has not yet dealt with the question as to whether the under-utilisation of land — or indeed other resources — should be tackled by taxation measures. This will be done when it considers incentives in the context of taxation.

Taxation of Gifts and Inheritances

25. As regards the recommendation that gifts and inheritances should be taxed as income, the Commission saw no strong case on equity grounds for any exemption thresholds. Because this approach could represent a considerable break with tradition, some members saw little alternative to providing some threshold. We dissent from this viewpoint. We also reject any provision for consanguinity reliefs. (Transfers between spouses would not bear any tax).

Wealth Tax

26. The Commission concluded that, provided income realised capital gains, gifts and inheritances are charged to income tax on a comprehensive basis and that dissavings are charged to direct expenditure tax, the justification for an annual wealth tax on equity or efficiency grounds was weak. It accepted that in these circumstances the main justification for such a tax is to change the distribution of wealth. We consider that a tax on wealth should be introduced for this purpose and agree with the Commission that

the most efficient method would be through progressive tax on accessions though this should not preclude other methods.

Incidence of Tax

27. On the basis of the information available to us, it is not possible to be precise as to the effect of the changes proposed on the incidence of direct taxation. We are satisfied that the result would be greater equity as between individuals and groups. The widening of the tax base and the more effective taxation of capital gains, gifts and inheritances would make possible a lower rate of direct tax while the phasing out of tax reliefs and allowances, the change to a tax credit system for personal allowances, the treatment of fringe benefits would mean a relatively higher amount of tax for the higher income groups.

Savings

The Commission's proposals would mean a reduction in tax reliefs for borrowing and increasing those for savings. This we support not only as a means of improving the equity of the tax system but also on grounds of economic efficiency.

Development Gains

29. The Commission has agreed that, in principle, all development gains should accrue to the community in full and has set out a possible scheme for ensuring that some of the benefit involved accrues to the taxpayer.

Unit of Taxation

30. We have had some difficulty in deciding our position on whether the unit of taxation should be the family or the individual. There are cogent arguments for both options. On balance, we agree that the tax unit should reflect the manner in which society organises itself for social and economic purposes. On this basis we accept the conclusion that income sharing should be assumed to exist between spouses (except where the spouses declare otherwise) and between parents and dependent children.

Tax Progressivity on Earnings

31. We would draw attention to the present degree of progressivity in the income tax system as it affects earnings since this has been very much in our minds in our approach to the problems raised by the Commission's work. In 1981/82, about 135,000 taxpayers (overwhelmingly PAYE taxpayers) paid tax at rates above the standard of 35 per cent. The estimate for 1982/83 following the March, 1982 budget, is 315,000 or about 40 per cent

of all income taxpayers. (This may be contrasted with the position in Britain where less than 5 per cent of taxpayers were liable at the higher tax rates in 1981/82). This situation cannot continue. The Commission's proposals must result in most taxpayers being liable to a lower rate of tax.

Conclusion

32. The Commission's conclusion that the direct taxation system is unfair, muddled and complicated and that a radical reform is necessary can scarcely be gainsaid. Its task was to devise a system which would be equitable, which would contribute to economic progress, which would be relatively simple and which would yield adequate revenue. In regard to tax equity, this in our view must mean that persons in the same situation should be equally treated and those more favourably placed should be required to pay more. The Commission's recommendations are specifically stated to be recommendations "in which the spirit of equity is the first and most important consideration". We trust that this preoccupation with equity will be noted and that the various proposals made in this report will be seen in this context.

DANIEL MURPHY
DONAL NEVIN

18 June, 1982

RESERVATION

by

MR. DONAL MURPHY

Paragraph 1.5

I do not accept that it is necessary for the Commission to propose a taxation system which is required to produce the amount of tax revenue being provided by the present system.

I believe that the Commission should have indicated its disapproval of the present gap between total tax revenue and Government expenditure, and its disapproval of the present level of current expenditure by the Government.

Chapter 3 Paragraphs 8.2, 32.30 and 32.27

I do not subscribe to the universal definition of equity which has been adopted as I believe that it is incorrect to apply that definition to all income-producing enterprises.

Income-producing enterprises differ for example in their nature, in their yields, and in the different levels of risk capital involved.

The fundamental differences between enterprises, and their problems, should be taken into account when deciding the system of taxation to be applied.

If the principle, of taxing on ability to pay were carried to its ultimate conclusion, then the end result would be that all individuals with similar allowances/credits would be left with equal amounts of after-tax income. I do not accept, for example that it is correct to apply the same system of taxation to a person whose life's savings and/or borrowings are employed to produce his income, and to another person whose income arises without requiring him to put one penny of his own capital at risk.

Paragraphs 4.10 to 4.12

With the commitment given in paragraph 1.5 to produce a system of taxation which will yield at least the present level of tax revenue, it is likely

that expenditure tax would have to be applied at a low level of income or the rates of expenditure tax would be very high.

Applying expenditure tax to low levels of income defeats the description and explanations of "simplicity" adopted in paragraphs 3.10 to 3.13.

Paragraphs 10.3 to 10.28

I do not accept any implication that people who strive to live in their own houses are in a privileged position tax-wise, or that the present tax treatment for those purchasing their own houses has been responsible for increasing the cost of housing. I do not accept that there is any basis for suggesting that an imputed income should be applied to house owner-occupiers, and do not therefore subscribe to the reasoning given in paragraph 10.108.1.

Paragraphs 10.88 to 10.89

I do not accept the conclusion as I believe that further encouragement should be provided for people to undertake training and education. It probably would be cheaper and more efficient to encourage people through taxation relief to undertake training and education, then for the State to provide all the facilities. I do not subscribe to the recommendations in 10.108.21.

Paragraph 10.108.15

I propose that medical insurance relief should be allowed at the standard rate of tax. Each individual should have the right to decide the level of medical insurance required and in so doing will relieve the State of setting up costly administrative departments to deal with same.

Paragraph 11.74.2

I do not subscribe to this recommendation as it proposes to exclude interest on money borrowed for house purchase as a deduction for tax purposes. The recommendation does not take account of the situation where inflation is not reflected in the value of the asset, e.g. falling land and house prices.

Paragraph 12.68.6

This recommendation implies that taxation should be applied to imputed income. I do not accept this.

Paragraphs 13.21 to 13.25

I do not subscribe to any argument which regards the non-taxation of unrealised gains as discrimination, and do not accept that there is a basis for taxing unrealised gains.

Paragraphs 13.43 to 13.47

Treating death as a disposal for capital gains tax, and subjecting the assets also to inheritance tax in effect means subjecting a portion of the assets to double taxation. I do not therefore subscribe to recommendation 13.77.5.

Paragraph 13.60

I do not subscribe to the implication here that reinvestment of realised capital gains should be discouraged and instead given to the State. I suggest that roll-over relief be provided for reinvestment in similar type assets (excluding development gains) which are productive.

Paragraph 13.77.10

I do not subscribe to this recommendation as for the vast majority of the over middle-aged group their residence represents their life's savings. The sale of this residence when it has to be made provides them with their income after retirement. To subject the capital gains to tax while most of it might arise from the good care and unaccounted maintenance provided, would deprive the retired people from income on which they would be dependent, and would probably steer them towards social welfare dependency.

Paragraph 13.77.11

I recommend the addition of

> "except where the real gains are reinvested in another private residence",

as dealt with in paragraph 13.58.

Chapter 18

While I accept the principle of a direct expenditure tax and its effect on income at present escaping taxation, I have serious reservations on its practicability, on the possible high compliance costs to individual taxpayers and on the level of income at which it may be applied.

Paragraph 31.9

This assumes that the self-employed person actually received all the relevant income in the year concerned. This generally is not the case as for many self-employed people, a significant portion of income earned in any one year may not in fact be received until the next year.

Paragraphs 31.10, 31.18 and 31.48

The proposal to charge tax on a current year basis for self-employed people in practice would mean payment of tax in advance of some income being actually received.

Such a proposal if adopted could seriously interfere with the business cash flow, and would increase the accountancy costs of those affected.

I do not subscribe to recommendations 1 and 2, and propose that the preceding year basis of assessment continues.

Chapter 32

The terms of reference given to the Commission required that due attention be paid "to the need to encourage development of the national economy".

In his address to the Commission the then Minister for Finance Mr. M. O'Kennedy, T.D., specifically mentioned the taxation of farming profits.

I believe that the Commission has not dealt adequately with the taxation of farming profits in the context of the contribution which farming can make to the national economy.

The Commission has decided to defer what I regard as essential elements of a proper taxation system for farming profits and deal with these in a later report under the heading "Incentives". I do not accept this interpretation.

Paragraph 32.11

Income arising from farming by its nature, by the return on capital invested, and by the amount of risk capital involved differs from the income arising to other enterprises and individuals. Accordingly, I do not agree that farmers should be taxed on the same basis as other individuals.

Paragraphs 32.33 to 32.36

I am satisfied that taking account of the nature of farming and the amount of time and capital involved in providing an income, the amount of taxation applied to farming profits as identified by a conventional accounts system

will directly affect the level of agricultural output. Put simply, additional output at increased cost and increased labour input will not be forthcoming if a significant proportion of the profits are seen to go in taxation.

Paragraph 32.34

The Commission has been informed that the Agricultural Institute could not predict any damage arising to their programme from the use of data from the Farm Management Survey to identify farm income for tax purposes.

Accordingly, I do not subscribe to the notion that it might reduce farmer co-operation with the Survey.

In fact, use of Farm Management Survey data would be a cheap and effective way of identifying farming income on those farms presently not subject to income tax.

Paragraph 32.37

I do not accept the conclusion and the preceding arguments and point to the use of a somewhat similar system in France where it has been instrumental in allowing and encouraging family farms to undertake and achieve high levels of output.

Paragraph 32.39

I do not accept this recommendation as it does not take account of the unique nature of farming.

Chapter: The Key Elements of Proposed Reforms

Paragraph 51

I believe that there are good reasons why exemption thresholds should apply for example to avoid the fragmentation of an essential productive unit in order to pay tax on a gift or inheritance (as recognised in paragraph 50).

Paragraph 52

I believe that there are generally accepted good reasons for consanguinity thresholds.

DONAL MURPHY

23 June, 1982

NOTE ON THE RESERVATION

of

MR. DONAL MURPHY

The preceding reservations of Mr. Donal Murphy concerning the contents and recommendations of the Report of the Commission on Taxation contain statements which are incorrect and misleading. The other members have therefore decided to deal with the points which require correction.

The following comments are solely intended to protect the integrity of the Commission's position: they do not relate to matters of disagreement or differences of opinion.

Reservation One: 1.5

The Commission has considered that it would be unrealistic to assume a sudden and significant decline in the requirements of revenue yield and that such an assumption would not be compatible with its terms of reference. The Commission's views are developed further in paragraph 1.31 to 1.33.

Reservation Three: 4.10 — 4.12

The Commission has satisfied itself that it is neither necessary nor likely "that expenditure tax would have to be applied at a low level of income or the rates of expenditure would be very high" and deals with this matter in paragraphs 18.72 to 18.78.

Reservation Four: 10.3 — 10.28

The Commission cannot be precluded from stating a line of reasoning, particularly if it happens to be correct in principle. In paragraph 10.26 the Commission rejected the principle of imputing income to house owners on practical grounds.

Reservation Seven: 11.74.2

This recommendation from which dissent is made must be read in the context of the recommendations in Chapter 13.

Reservation Nine: 13.21 — 13.25

We have recommended that capital gains be charged to tax on realisation only.

Reservation Eleven: 13.60

There is no implication anywhere in this report "that reinvestment of realised gains should be discouraged and instead given to the State".

Reservation Fourteen: 31.9

The assumption "that the self-employed person actually received all the relevant income in the year concerned" is not made and the matter is covered in paragraph 31.10.

Reservation Twenty: 32.34

The Commission was informed that the Agricultural Institute could not predict what effect the use of its data for tax purposes would have on the Farm Management Survey.

RESERVATIONS AND OBSERVATIONS

by

PATRICK P. O'NEILL.

I have to make the following reservations and observations to Conclusions and Recommendations contained in Part 1 of the Commissions report.

Treating death as a disposal for capital gains tax and subjecting the Assets also to inheritance tax in effect means a burden of taxation which could result in the fragmentation of productive units. In my opinion the recommendation 13.77.5 will have this result.

The recommendations 13.77.10 and 13.77.11 cover the principal private residence. In my opinion there should be no capital gains tax payable where the proceeds are reinvested in another private residence.

The thrust of the report in endeavouring to suggest an equitable system of taxation in my opinion will place greater burden on the State to provide services, e.g. housing, education, medical, social welfare; these services could be provided in a taxation system through tax credits/allowances and relieve the State of setting up costly administrative departments to deal with same.

PATRICK P. O'NEILL.

18th June 1982.

RESERVATION

by

MR. RAYMOND O'NEILL, S.C.

1. I have to express the following reservations to the views and recommendations contained in the Commission's report.

2. It is recommended in the report that capital gains tax should be charged on the disposal of property which occurs on the death of the owner and that inheritance tax should also be charged in respect of the same property. This appears to me to constitute double taxation in respect of the same property on the same occasion (death of the owner) and, in my view, it is no answer to say that the capital gains tax will be deducted from the value of the asset for purposes of inheritance tax: See paragraph 13.47.

3. The same observation applies, in my view, in relation to gifts, and also in relation to the withdrawal of property from the family unit upon a child leaving that unit: See paragraph 34.14.

4. I consider that in such circumstances credit should be given against the inheritance or gift tax payable in respect of the property for the capital gains tax payable in respect of the same property.

5. It is recommended in the report that the existing exemption from capital gains tax or a gain on the disposal of a principal private residence should be withdrawn: See Paragraph 13.58 and Paragraph 13.77 (10). When a principal private residence is disposed of, the proceeds would normally be needed and used for the purchase of another residence, and it would, in my view, be inequitable to charge tax on the gain in such circumstances. Accordingly, I am unable to agree with this recommendation. If the proceeds of sale of the residence were not used for the purchase of another residence, then the exemption should be withdrawn.

RAYMOND O'NEILL

18th June, 1982.

Appendices

APPENDIX 1

LIST OF SUBMISSIONS

Government Departments
Department of Agriculture.
Department of Fisheries and Forestry.
Department of Industry, Commerce and Tourism.
Department of the Public Service.
Department of Social Welfare.
Commissioner of Valuation.

Organisations
Aer Lingus.
Agricultural Consultants Association.
Agricultural Credit Corporation Ltd.
Allied Irish Investment Bank Ltd.
Arts Council, The
Association of Chambers of Commerce of Ireland, The
Association of Equipment Suppliers.
Association of Higher Civil Servants.*
Association of Inspectors of Taxes.*
Association of Scientific, Technical and Managerial Staffs.
British & Irish Steam Packet Co. Ltd.
Bord Fáilte.
Cement Roadstone.
Central Bank of Ireland.
Challenge.*
Chartered Institute of Transport in Ireland.
Cherish.*
Childminders' Union.
Civil Service General Council Staff Panel.
Civil and Public Service Staff Association.
Claremorris Guild of the Irish Countrywomen's Association.
Clondalkin Paper Mills Ltd.
Coal Distributors Ltd.
Communist Party of Ireland, The
Community Information Centre Claremorris, The
Confederation of Irish Industry, The*

Conlon, John Ltd.
Construction Industry Federation.
Consultative Committee of Accountancy Bodies — Ireland, The*
Córas Iompar Éireann.
Córas Tráchtála.
Cork Chamber of Commerce.
Corporation of Insurance Brokers in Ireland, The*
Council for Social Welfare, The (A Committee of the Catholic Bishops' Conference)
Council for the Status of Women.
Craig Gardner and Company.
Deloitte, Haskins and Sells.
Dublin Chamber of Commerce.
Doherty, James J. Ltd.
Dublin Council of Trade Unions.*
E.S.B. Officers Association.
Family Operated Dairy Farms.
Federated Union of Employers.
Federation of Trade Associations, The
First General Unit Managers Ltd.
Financial Information Service Centres.
Foras Forbatha Teoranta, An
Foras Talúntais, An
Garda Síochána Pensioners Association.
Glasthule Eagles Voluntary Social Servers.
Grand Lodge of Freemasons.
Griffin and Company, J.J.
Heiton McFerran Ltd.
Hugh Jordan and Company Ltd.
IFA/ICMSA Co-ordinating Group.*
Incorporated Law Society of Ireland, The
Industrial Credit Co. Ltd., The
Industrial Development Authority.*
Inspector of Taxes Association.*
Institute of Certified Public Accountants in Ireland, The
Institute of Chartered Secretaries and Administrators.
Institute of Management Accounts.
Institute of Personnel Management.
Institute of Taxation in Ireland, The*
Irish Association of Company and Commercial Accountants, The
Irish Association of Distributive Trades Ltd.
Irish Association of Pension Funds, The
Irish Auctioneers and Valuers Institute.
Irish Banks Standing Committee.
Irish Bloodstock Breeders' Association, The
Irish Building Societies Association.*

Irish Cattle Traders and Stockowners Association.
Irish Chamber of Shipping.
Irish Conference of Professional and Service Associations.
Irish Co-operative Organisation Society Ltd.
Irish Family League, The
Irish Federation of Self-Employed Ltd. The*
Irish Finance Houses Association Ltd.
Irish Fishermen's Organisation Ltd.
Irish Hardware Association.
Irish Institute of Secretaries and Administrators, The
Irish Insurance Association, The
Irish League of Credit Unions, The*
Irish National Bookmakers Association.
Irish Pensions Trust Ltd.
Irish Port Authorities Association, The
Irish Shell Ltd.
Irish Transport and General Workers' Union.
Irish Taxes Union.*
Irish Timber Growers Association.
Labour Women's Council, The
Licensed Vintners Association.
Life Offices' Association of Ireland.*
Lighting Group Ltd.
Limerick Chamber of Commerce.
Local Government and Public Services Union.
Macra Na Feirme.
National Land League.
National Salmon and Inshore Fishermen's Association.
National Social Service Council.
Nenagh Urban District Council.
National Board for Science and Technology.
New Ireland Assurance Co. Ltd.
Patterson, Kempster and Shortall, Chartered Quantity Surveyors.
Planned Sharing Research Association.
Price Waterhouse and Company.
Radio and Electronic Officers Union.
Regional Technical College Galway, School of Business and Social Studies.
Representative Church Body, The
Retired Civil Servants Association.
Retired Teachers Association.
Royal Institution of Chartered Surveyors, The*
Saturn Management Ltd.
Scafform Ltd.
School of Economic Science, The
Securities Industry Panel, The
Shannon Free Airport Development Company Ltd.

Single Persons Against Discrimination.
Sinn Féin, The Workers' Party.
Socialist Labour Party.
Socialist Tax Committee.
Society of the Irish Motor Industry, The
Society of St. Vincent de Paul.
Stock Exchange, The
Trinity College, Dublin.
Trustees of the Methodist Church in Ireland, The
Union of Students in Ireland.
Union of Voluntary Organisations for the Handicapped.
Union of Professional and Technical Civil Servants.
Wine and Spirit Association of Ireland.

Individuals
Mr. Charles Acton.
Mr. William Allen.
The Earl of Altamont.
Mr. David Bateman.
Ms. Enid Binks.
Mr. Tim Boyle.
Mr. John V. Breen.
Mr. G.F. Browne.
Mr. Cathal M. Brugha.
Mr. Richard Burke.
Mr. Brendan Cardiff.
Ms. Catherine Carroll.
Mr. D.J. Coghlan.
Mr. F.F.N. Corry.
Mr. Terry Cooney.
Mr. M. Cronin.
Dr. Raymond Crotty.
Ms. Gladys Crowley
Mr. J.A. Crowley.
Ms. Letitia Cusack.
Mr. Christy Delaney.
Mr. Leo M. Duffy.
Ms. Kathleen Duggan.
Mr. W. Dunne.
Mr. Michael Durnin.
Ms. Marie Egan.
Mr. Noel Fanning.
Cllr. Eithne Fitzgerald.
Ms. Catherine E. Flanagan.
Mr. T.P. Flanagan.
Mr. P. Francis.

Mr. T. Fulier.
Mr. Donal Garvey.
Mr. S. Glennon.
Mr. Patrick Griffin.
Ms. M. Hallahan.
Mr. John Harrington.
Mr. W.J. Hayes.
Ms. Mary Healy.
Mr. Michael Horsman.
Mr. Brian Hussey.
Mr. Roger Hussey.
Ms. Katie Kahn-Carl.
Sir Richard Keane.
Ms. Margaret Kearney.
Mr. S.J. Kearney.
Mr. Aidan Kearney.
Mr. John Kent.
Knight of Glin.
Mr. John J. Landers.
Mr. Walter L. Larsen
Mr. J. Lefroy.
Mr. Eugene Long.
Mr. Charles Lysaght.
Ms. Fidelma Maguire.
Ms. D. Manifold.
Mr. Richard W. Mann.
Mr. Edward Meagher.
Mr. T.M. Molloy.
Mr. Christopher P. Moran
Mr. F.O. Morgan.
Mr. Graham B. Moss.
Ms. Marie Mullarney.
Ms. Anne H. Mullin.
Mr. David A. Murray.
Ms. Mary Murray.
Mr. P.J. MacGillycuddy.
Mr. John A. McElhinney.
Mr. Ivor McElveen.
Mr. A. McFadden.
Dr. Padraig McGowan.
Rev. Prof. Gerald McGreevy.
Mr. Aidan McKenna.
Mr. William McNeice.
Mr. Eamonn McNulty.
Mr. Maurice O'Brien.
Mr. Finbar O'Callaghan.

Mr. John O'Callaghan.
Ms. Noreen O'Cáthain.
Ms. Judith J. O'Connell.
Gearoid O'Cúinneagáin, Uasal.
Mr. Kevin M. O'Dea.
Mr. Sean O'Driscoll.
Mr. W. O'Driscoll.
Mr. D.B. O'Flynn.
Donnchadh O'Luasaigh, Uasal
Mr. J.M. O'Mahony.
Mr. Ciarán O Mulláin.
Mr. G.J. O'Shaughnessy.
Ms. M. O'Sullivan.
Mr. M. O'Toole.
Mr. Maurice Pierse.
Mr. John M. Pinder.
Mr. Eamonn Pitts.
Mr. David Pyott.
Ms. Betty Quinn.
Mr. L.P. Ricks.
Mr. Howard W. Robinson.
Mr. Brian Rutledge.
Mr. A.G. Ryan.
Ms. Irene Ryan.
Mr. Patrick Ryan.
Mr. F. Salter.
Ms. May Savage.
Ms. Yvonne Scannell.
Mr. R. J. Somers.
Mr. Joseph Stockdale.
Ms. Ann Warner.
Mr. Timothy Winter.

*The asterix indicates that in addition to making a written submission these organisations also made an oral presentation to the Commission.

APPENDIX 2

OFFICIAL BODIES WHO ASSISTED THE COMMISSION

The following list gives the representatives of Governments and official bodies who assisted us in various ways — by submitting papers formally or informally, processing statistical information, joining in discussion, offering advice and comment or supplying documentation.

Representatives of Government Departments, Offices and Bodies:

Australia

Taxation Office,
Treasury

Canada

Department of Finance.

France

French Embassy,
Ministère des Finances (Ministry of Finance).

International Organisations

Commission of the European Communities,
Organisation for Economic Co-operation and Development.

Ireland

Central Statistics Office,
Department of Agriculture,
Department of the Environment,
Department of Finance,
Department of Foreign Affairs,
Department of Industry, Commerce and Tourism,*
Department of Health,
Department of Labour,
Department of the Public Service.

*Now restructured as the Departments of Industry and Energy, and Trade, Commerce and Tourism.

Department of Transport,
Department of Social Welfare,
Office of the Revenue Commissioners,
Valuation Office.

Isle of Man

Office of the Assessor of Income Tax.

Luxembourg

Administration Des Contributions Directes et Des Accises (Office of the Direct Taxation and Excise Duties).

Netherlands

Royal Netherlands Embassy

New Zealand

Inland Revenue Department,
New Zealand Embassy,
New Zealand Planning Council,
Treasury

Sweden

Embassy of Sweden.

United Kingdom

Board of Inland Revenue,
Government Accountancy Service.

APPENDIX 3

LIST OF COMMISSIONED WORK

Professor John Bristow, Trinity College Dublin	Papers on "The Unit of Taxation", "The Taxation of Capital Gains" and on "Some Aspects of Capital Taxation and Agricultural Land".
Davy, Kelleher McCarthy Ltd., Economic Consultants.	Paper on "The Taxation of Financial Institutions".
Institute of Chartered Accountants in Ireland	Seminar for Commission on Current Cost Accounting.
Mr. John Kay, Director of The Institute of Fiscal Studies	Oral consultancy on the question of a direct expenditure tax.
Professor Cedric Sandford, University of Bath.	Critical review of the final draft of the report.

APPENDIX 4

INCIDENCE OF TAXATION—INTERNATIONAL EXPERIENCE

1. Experience in other countries suggests that employees may well attempt to offset the effects of higher taxation by way of higher gross wage increases — the phenomenon of "wage retaliation". In 1970, the Economic Council of Canada stated that "an increasing number of groups are taking not only price changes but also tax changes explicitly into account in their approaches to income bargaining". Dernburg[1] had found that some European Governments have taken the threat of wage retaliation against direct taxes very seriously:

> "In Austria, the tax reduction of 1972 was the product of a direct negotiation between the unions and the Austrian Government. In Sweden, the Swedish Confederation of Professional Associations . . . set its wages demands in terms of real take home pay in 1966, and the Swedish Government eliminated the 5 per cent social security withholding tax in 1973, openly recognising the need for tax relief as a means of reducing wage demands".

2. In Germany, before the 1975 tax reforms, some trade unions expressed their global target rates of wage increases on a net-of-tax basis (also adjusted for the rise in prices), perhaps reflecting the fact that income tax rates were unchanged between 1965 and 1974. Similar developments were apparent in the Netherlands until the introduction in 1971 of indexation. In Finland, since 1973, taxation policy has been one of the subjects included in the annual negotiations about incomes policy between unions, employers, farmers and Government. In Sweden, the tax reforms undertaken between 1974 and 1976 were clearly aimed at attaining a slower increase in wages and thereby in prices, by shifting from a progressive income tax to a proportional payroll tax on employers.

3. Reaction in some OECD countries to the oil price increase recorded in 1979 and 1980 indicates a changed pattern of behaviour. The OECD

[1] T. F. Dernburg "*The Macroeconomic Implications of Wage Retaliation against Higher Taxation*" IMF Staff Papers. November, 1974.

Economic Outlook published in July, 1980 summed up the position as follows in relation to wage determination:

> "Generalisations concerning the response of wage earners and employers to the simultaneous phenomena of rising unemployment and accelerating inflation are difficult. But a common problem in the past has been that the reaction of nominal wages to accelerating inflation has typically out-weighed the dampening effects of weaker labour markets, at least in the short-run. While the cyclical sensitivity of wages differs among countries, what is novel in the present situation is the remarkably modest response of nominal wages to the acceleration of consumer prices to date. While some acceleration of nominal wages in 1980 appears inevitable . . . . . it is likely to be a small fraction of the comparable rise in consumer prices".

APPENDIX 5

TAXATION AND THE DISTRIBUTION OF INCOME

1. A large volume of statistical material relating to the distribution of direct taxation is generated as a by-product of the administration of income tax. Part of this material is published in the Annual Reports of the Revenue Commissioners. The Revenue Commissioners' statistics have considerable advantages over a voluntary sample survey like the Household Budget Survey in that they are based on a census drawn from administrative records and the incomes covered are accurate, in so far as legal sanctions can ensure accuracy in tax returns. There are, however, a number of limitations which should be borne in mind. The following are the most important:

(i) Categories of income which are not liable to tax are omitted, e.g. short-term social insurance benefits, scholarships and some fringe benefits provided to employees.

(ii) The income, which is the basis of most of the tables published by the Revenue Commissioners, excludes interest paid in full, superannuation contributions, allowable medical and life assurance premiums. Income from self-employment is included after deducting capital allowances and losses carried forward.

(iii) The imputed rental income of owner-occupied housing is omitted.

(iv) Employers' social insurance contributions and both employers' and employees' superannuation contributions are omitted.

(v) The income covered relates only to part of the year for those who start work or die during the year and for women widowed or married during the year because they are counted as separate units for only part of the year.

(vi) Some income does not come to the attention of the Revenue Commissioners because of tax evasion.

(vii) Some income is outside the definition of income due to the use of artificial arrangements which have the avoidance of tax as their primary objective.

(viii) Incomes below the exemption limit for tax purposes are excluded in certain circumstances.

(ix) The 1979/80 statistics (the latest available) are those adjusted as at 18 May, 1980. Adjustments made after that date have not been taken into account.

(x) Capital gains, which are distributed unequally, are not included as income.

TABLE 5.1

Distribution of Total Income for Income Tax Purposes 1979/80

Range of total income		Single and widowed persons		Married persons		All persons		Total income		Total tax		Average rate of tax on total income
£	£	000's	%	000's	%	000's	%	£m	%	£m	%	%
0	3,000	253.7	51.7	66.5	18.4	320.3	37.6	506.1	13.0	42.4	4.7	8.4
3,000	6,000	183.2	37.4	149.0	41.2	332.2	39.0	1,449.4	37.2	256.7	28.3	17.5
6,000	10,000	44.0	9.0	108.4	30.0	152.4	17.9	1,150.3	29.2	280.0	30.9	24.3
10,000	20,000	7.9	1.6	33.2	9.2	41.2	4.8	527.3	13.5	188.6	20.8	35.8
20,000	and over	1.6	0.3	4.4	1.2	6.0	0.7	266.2	6.8	139.3	15.3	52.3
Totals		490.4	100.0	361.6	100.0	852.0	100.0	3,899.3	100.0	907.0	100.0	23.3

2. Table 5.1, which is derived from the data from the forthcoming Revenue Commissioners' Report for 1980, gives a broad picture of the distribution of total income for income tax purposes. It shows clearly that income tax is progressive within itself, since the top 0.7 per cent of income earners pay over 15.3 per cent of the tax, while they account for 6.8 per cent of total income.

3. Table 5.2 summarises the information that will appear in the Revenue Commissioners' Annual Report for 1980 on the distribution of income and tax payable by marital status.

TABLE 5.2

Distribution of Income and Income Tax 1979/80 by Marital Status

Marital Status	Total no. of persons	Total income	Total tax	Average income	Average rate of tax
	000's	£m	£m	£	%
Single Male	242.9	907.9	237.8	3,738	26.2
Single Female	198.7	592.7	126.0	2,979	21.6
Widowers	13.8	58.7	15.2	4,254	25.9
Widows	35.0	108.6	24.4	3,103	22.5
Married Couples Wife earning	84.9	590.2	146.9	6,952	24.9
Married Couples Wife not earning	276.7	1,641.2	354.8	5,931	21.6
Totals	852.0	3,899.3	907.0	4,577	23.3

Table 5.2 shows that single and widowed persons account for 42.8 per cent of total income and pay 44.7 per cent of total tax. Married couples where the wife is earning have 15.1 per cent of total income and pay 16.2 per cent of total tax, while married couples where the wife is not earning have 42.1 per cent of total income and pay 39.1 per cent of total tax.

4. Table 5.3 summarises the information that will appear in the Revenue Commissioners' Annual Report for 1980 on the distribution of income and tax payable by different categories of income earners.

TABLE 5.3

Distribution of Income and Income Tax 1979/80 by Main Income Source

Main Income Source	Total no. of persons	Total income	Total tax	Average income	Average rate of tax
	000's	£m	£m	£	%
PAYE (Employees)	740.3	3,103.1	653.8	4,192	21.1
Schedule D Earned (Self-employed)	96.9	731.1	234.9	7,545	32.1
Schedule D Unearned (Investment income)	14.9	65.1	18.3	4,369	28.1
Totals	852.1	3,899.3	907.0	4,576	23.3

5. The shares of income and tax accounted for by the main categories of income recipient are summarised in Table 5.4.

TABLE 5.4

Share of Income and Income Tax 1979/80 by Main Income Source

Main Income Source	Share of Income	Share of Tax
	%	%
PAYE (Employees)	79.6	72.1
Schedule D Earned (Self-Employed)	18.7	25.9
Schedule D Unearned (Investment Income)	1.7	2.0
Totals	100.0	100.0

Particular care should be taken before drawing conclusions from Tables 5.3 and 5.4 as some of the figures for Schedule D taxpayers are based on assessments under appeal. Receipts from PAYE also include tax paid by company directors on their salaries and also tax on non-PAYE income which is collected by reducing PAYE allowances.

6. Table 5.5 shows the distribution of personal income on the definition used by the Revenue Commissioners before and after tax for the year 1979/80.

TABLE 5.5

Distribution of Personal Income 1979/80

Decile Group	Percentage Shares of:		
	Total Income	Total Income Tax	Post-tax Income
Top 1-10 per cent	29.1	46.52	23.9
11-20 per cent	15.8	15.95	15.8
21-30 per cent	12.8	11.23	13.2
31-40 per cent	11.0	8.93	11.6
41-50 per cent	9.0	6.55	9.7
51-60 per cent	7.6	5.06	8.4
61-70 per cent	6.3	3.53	7.1
71-80 per cent	4.5	1.71	5.4
81-90 per cent	2.9	0.50	3.6
91-100 per cent	1.0	0.02	1.3
Totals	100.0	100.00	100.0
Top 20 per cent	44.9	62.47	39.7
Top 50 per cent	77.7	89.18	74.2
Bottom 20 per cent	3.9	0.52	4.9

Table 5.5 shows that the income tax system reduces the inequality of the distribution of post-tax income.

7. The figures in these tables are annual figures and as such they are subject to one further important qualification. It is tempting with annual statistics to argue as if families in each income group are there all their lives, which, of course, is not the case. Almost everybody's income starts, on entry to the work force, at a much lower level than it reaches later in their working life and falls on retirement. Many people, too, have years of exceptionally low income during a normal career because of sickness or unemployment.

8. Were it possible to ascertain the distribution of income in terms not of annual income but of the probable average lifetime income, such a distribution would (after eliminating the general rise in incomes resulting from economic progress) be much more equal than any annual figures. The great majority of individuals in the lower ranges of the annual distribution (the sick, the aged and the unemployed) would move into higher income groups. Many of those towards the top on the basis of annual statistics (persons at the temporary peak of their careers or old enough to have incomes from their own savings and from inheritances) would move into lower groups. The bulk of the population would be concentrated in the middle ranges.

9. There are no data in Ireland regarding age-related earnings. However, the Royal Commission on the Distribution of Income and Wealth[1] examined the question in the United Kingdom and drew the following conclusions:

> "The earnings profiles typically have a steep increase in average earnings in the first years of working life followed by a plateau and then a decline in the last years. Non-manual workers take longer to reach their maximum earnings than manual workers, but their maximum is higher. Women's earnings rise more slowly and to a lower plateau than men's. Age affects earnings to a greater extent in higher paid occupations. The profiles are based on average earnings in different age groups at one particular time".

Components of Personal Income

10. An indication of the change in the relative shares of personal income over time between various sectors may be derived from the National Accounts, prepared annually by the Central Statistics Office. Personal income is defined as the aggregate income from all sources in cash and in kind, whether from productive services or not, at the disposal of individuals permanently resident in the State. As such, it is considerably wider than the definition used by the Revenue Commissioners.

11. Table 5.6 shows the distribution of personal income for 1960, 1970 and 1979 (the latest year for which figures are available).

[1] *Report No. 8 of the Royal Commission on the Distribution of Income and Wealth*, HMSO, October, 1979, paragraph 14.15.

TABLE 5.6

Components of Personal Income: Ireland

Component	1960	1970	1979
	%	%	%
Remuneration of employees	52.8	59.4	59.9
of which			
Agriculture	3.0	1.7	0.8
Domestic non-agriculture	48.2	56.0	55.9
Foreign	0.9	0.1	0.1
Employers' contribution to social insurance	0.6	1.6	3.1
Income of independent traders, etc	27.1	19.3	17.1
of which			
Agriculture	20.1	13.0	10.5
Non-agriculture	7.1	6.3	6.6
Net interest, dividends and rent (including imputed rent)	10.7	8.4	8.5
Current transfers to households	9.3	12.9	14.5
	100.0	100.0	100.0

Source: National Income and Expenditure.

12. Over the nineteen-year period, the share of income from employment increased by 7.1 percentage points and the share of transfer income rose by 5.2 percentage points. These increases were offset by a reduction of 10 percentage points in the share of income from self-employment, which was mainly due to a fall of 9.6 percentage points in the share of farmers. There was also a reduction of 2.2 percentage points in the share of investment income and rents.

Household Budget Survey

13. The statistics published by the Revenue Commissioners only provide information relating to the distribution of income tax which accounts for roughly 30 per cent of total tax revenue. For a fuller picture of the distribution of taxation it is necessary to rely on the Household Budget Surveys by the Central Statistics Office.

14. One of the main differences between the Revenue Commissioners' data and the Household Budget Survey data is in the definition of the income unit. The Household Budget Survey works with a definition of a "household", namely, one person living alone or a group of people living at the same address, having meals prepared together and with common housekeeping. One of the crucial points at issue is the extent to which income is, in fact, shared in the wider units. It is probably reasonable to assume that income is shared in the case of married couples, but this assumption may be less reasonable when we are dealing with a family with, say, adult children living at home. This reservation may reduce the value of the data based on the household unit for purposes of taxation policy.

15. Taxes paid in cash are readily identifiable from Household Budget Survey data but taxes on goods and services have to be estimated from expenditure information. It is not possible to allocate taxes specific to the corporate sector.

16. The major advantage of the Household Budget Survey is that it covers incomes below the effective exemption limit for income tax purposes and some forms of income which are not subject to tax, such as short-term social insurance benefits. However, the data have a number of important limitations. Firstly, the results generally tend to underestimate the income people actually receive due to the "understandable reluctance of the public to divulge such personal and confidential information". The expenditure estimates are far more reliable than those derived from incomes, except in the case of alcoholic drink. The relevant expenditure estimates under this heading have been corrected before their value-added tax and fiscal duty content was imputed. The unreliability of the income estimates is borne out by the fact that, in many instances, they are less than the corresponding expenditure estimates. The definition of income used is deficient in that it excludes such items as capital gains, employers' superannuation and social insurance contributions and the imputed rent of owner-occupiers and tenants who occupy property at rents below market levels.

17. The Central Statistics Office published a study in January, 1980 entitled "The Redistributive Effects of State Taxes and Benefits on Households Incomes in 1973". The taxes covered in the survey accounted for about 76 per cent of public authorities' income from taxes of all kinds in 1973/74, while the benefits considered covered about 56 per cent of public authority current expenditure in the same year. The redistributive impact of Government activity is measured by the ratio of final income to indirect income. Where this ratio exceeds 1, the category of persons is a net beneficiary from the package of taxes and benefits being examined. Direct household income is defined to include all money receipts of a recurring nature which accrue directly to the household regularly, together with the retail value of own garden or farm produce consumed by the household before the deduction of taxes or the addition of cash benefits paid by the State. Final household income is the income that remains after all taxes and benefits are covered in the analysis.

The Redistributive Effect of the Tax System

18. Table 5.7 shows the average level of individual taxes classified by gross income for all households for 1973. Gross income includes all money receipts of a recurring nature which accrue directly to the household regularly at annual or more frequent intervals together with the value of any free goods regularly received by household members and the retail value of own garden or farm produce consumed by the household before

TABLE 5.7

Percentage of Gross Income Paid in Taxes: All Households 1973

Income level per week*		Under £7	£7-£15	£15-£20	£20-£25	£25-£30	£30-£35	£35-£40	£40-£50	£50-£60	£60-£80	£80+	Average
Average gross income	£	5.18	10.94	17.51	22.54	27.52	32.41	37.46	44.65	54.83	69.16	111.75	40.22
Index Av.=100		13	27	44	56	68	81	93	111	136	172	278	100
Direct Taxes	%	0.6	1.2	3.2	6.8	6.9	8.4	8.9	9.9	10.9	12.4	11.7	9.8
of which:													
Income tax	%	0.3	0.7	1.6	4.0	4.1	5.6	6.5	7.5	8.7	10.2	10.3	7.8
Social insurance	%	0.3	0.5	1.6	2.8	2.8	2.8	2.4	2.4	2.2	2.2	1.4	2.0
Indirect taxes	%	34.8	29.5	23.7	23.6	21.8	21.8	21.5	19.3	18.4	16.9	13.0	18.5
of which:													
Rates	%	7.2	5.6	3.3	3.0	2.9	2.7	3.2	2.2	2.0	1.7	1.4	2.3
Motor taxation	%	0.8	0.5	0.7	0.8	0.7	0.8	0.8	0.7	0.7	0.6	0.5	0.6
VAT	%	10.5	7.7	6.5	6.8	6.0	6.0	6.1	5.9	5.6	5.1	4.2	5.5
Fiscal Duties	%	15.4	15.1	12.6	12.5	11.8	11.8	11.0	10.1	9.8	9.2	6.7	9.8
Licences	%	0.9	0.6	0.6	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.2	0.3
Total taxation	%	35.4	30.7	26.9	30.4	30.2	30.2	30.4	29.2	29.3	29.3	24.7	28.3
Ratio of Final Income to Direct Income		5.77	2.40	1.46	1.16	1.01	1.01	.96	.94	.89	.86	.84	.96

*Between September 1973 and September 1981 average weekly earnings in transportable goods industries increased by a factor of 3.852. The following table gives the 1981 income equivalents.

1973 Income £	1981 Income £	1973 Income £	1981 Income £
7	27	35	135
15	58	40	154
20	77	50	193
25	96	60	231
30	116	80	308

TABLE 5.8

Total Taxes as a Percentage of Gross Income Paid in Taxes: All Households by Size 1973

Household		1 Person	2 Persons	3 Persons	4 Persons	5 Persons	6 Persons	7 Persons	8 Persons	9 Persons	10+ Persons	Average
Average Gross Income per week	£	13.88	29.33	40.04	47.89	48.19	52.08	55.46	57.10	58.18	64.33	40.22
Direct Taxes of which:	%	9.1	10.3	11.2	11.2	10.3	9.2	7.4	7.6	8.0	7.5	9.8
Income tax	%	7.9	8.7	9.2	9.1	8.2	7.0	5.3	5.2	5.4	4.6	7.8
Social insurance	%	1.2	1.6	2.0	2.1	2.1	2.2	2.1	2.4	2.6	2.9	2.0
Indirect taxes of which:	%	17.9	19.3	18.9	18.8	19.1	17.9	17.4	19.1	18.1	16.6	18.5
Rates	%	4.7	3.1	2.2	2.3	2.2	2.7	1.7	1.5	1.4	1.2	2.3
Motor taxation	%	0.5	0.6	0.7	0.7	0.7	0.8	0.6	0.6	0.6	0.5	0.6
VAT	%	4.4	4.9	5.4	5.6	5.9	6.0	5.9	6.2	6.1	5.5	5.5
Fiscal Duties	%	7.9	10.3	10.3	9.8	10.0	11.8	8.9	10.5	9.7	9.2	9.8
Licences	%	0.4	0.4	0.16	0.4	0.3	0.5	0.3	0.3	0.3	0.2	0.3
Total Taxation	%	27.0	29.6	30.1	30.0	29.4	27.1	24.8	26.7	26.1	24.1	28.3
Ratio of Final Income to Direct Income		1.13	.90	.86	.85	.92	.98	1.06	1.11	1.18	1.25	.96

deduction of taxes. It also includes cash benefits paid by the State such as children's allowances and unemployment benefits.

19. Table 5.7 shows that the tax system was broadly regressive in 1973 up to an income level about half the national average. It was proportional from that point up to about twice average incomes, when it became regressive. Direct taxes were progressive. However, employees' social insurance contributions were regressive above average income levels. Indirect taxes were regressive with value-added tax being slightly less regressive than fiscal duties. Rates were also regressive. Table 5.7 also shows that households with a gross weekly income of up to £35 per week were net beneficiaries from the package of State taxes and benefits examined, while households over that income level were net contributors. In 1973, average male earnings in transportable goods industries were £36 per week.

20. Table 5.8 shows the average level of individual taxes classified by gross income for all household by household size in 1973. A number of conclusions may be drawn from the table. Firstly, average gross weekly household income increased as household size increased. Total taxation was above average in the case of households with between two and five persons and below average in other cases. This pattern was exhibited for both direct and indirect taxes, with the exception that indirect taxes were above average in the case of eight-person households. Rates bore most heavily on small households, while value-added tax was above average for households with over three persons. No clear pattern emerged in the case of fiscal duties. Net beneficiaries from State taxes and benefits were one-person households and households with seven or more persons.

TABLE 5.9

Total Taxes as a Percentage of Gross Income of All Households by Livelihood Status of Head of Household 1973

Livelihood Status		Self-Employed	Employee	Out of work	Retired	Other	Average
Average Weekly Gross Income	£	42.27	49.18	25.73	26.15	23.60	40.22
Direct Taxes of which:	%	4.0	13.8	8.1	7.9	8.3	9.8
Income Tax	%	3.1	11.1	5.2	6.2	6.2	7.8
Social Insurance	%	0.9	2.7	2.9	1.7	2.1	2.0
Indirect Taxes of which:	%	17.1	18.5	25.5	21.8	18.4	18.5
Rates	%	1.5	2.4	2.4	3.0	3.3	2.3
Motor Taxation	%	0.7	0.7	0.5	0.6	0.4	0.6
VAT	%	5.2	5.6	7.1	5.8	5.4	5.5
Fiscal Duties	%	9.4	9.5	15.0	12.1	8.9	9.8
Licences	%	0.3	0.3	0.5	0.3	0.4	0.3
Total Taxation	%	21.1	32.3	33.6	29.7	26.7	28.3
Ratio of Final Income to Direct Income		1.00	.84	1.95	1.21	1.33	.96

21. Table 5.9 shows that employees had the highest average gross income and were the only category not to benefit from State taxes and benefits. Total taxation was above average in cases where the head of the household was either employed or out of work. Direct taxes were extremely low in the case of self-employed persons due mainly to the fact that income tax was just over one-quarter of the percentage of income paid by employees. It was half the percentage paid by households where the head of household was retired. Rates bore heavily on retired persons, while value-added tax and fiscal duties were very significantly higher than average where the head of the household was out of work.

22. Table 5.10 analyses the percentage of gross income paid in taxes by urban, rural farm and rural non-farm households.

TABLE 5.10

Total Taxes as a Percentage of Gross Income of Urban and Rural Households 1973

Type of Household		Urban	Rural Farm	Rural Non-Farm	Average
Average Gross Weekly Income	£	42.90	40.11	33.01	40.22
Direct Taxes	%	12.0	2.6	9.1	9.8
of which:					
Income tax	%	10.3	1.9	6.6	7.8
Social insurance	%	2.3	0.9	2.5	2.0
Indirect taxes	%	19.5	15.3	19.4	18.5
of which:					
Rates	%	3.1	0.8	1.1	2.3
Motor taxation	%	0.6	0.5	0.8	0.6
VAT	%	5.6	4.8	6.1	5.5
Fiscal Duties	%	9.8	8.9	11.0	9.8
Licences	%	0.4	0.3	0.4	0.3
Total taxation	%	32.1	18.1	28.5	28.3
Ratio of Final Income to Direct Income		.90	1.06	1.05	.96

23. Table 5.10 shows that rural non-farm incomes were significantly lower than other incomes. The main conclusions to be drawn from the table are that urban households were net contributors after State taxes and benefits were taken into account, while rural households were net beneficiaries. The level of taxation was highest in the case of urban households and lowest in the case of rural farm households. This was due mainly to the very low proportion of income paid in income tax by rural farm households. Indirect taxes were also lowest in the case of these households. Particularly surprising is the fact that rates on urban households were almost four times the amount paid by rural farm households when expressed as a proportion of gross income.

24. Table 5.11 analyses the level of taxation as a percentage of gross income by household tenure for all households in the State.

TABLE 5.11

Total Taxes as a Percentage of Gross Income of All Households by Household Tenure 1973

Household Tenure		Owned Outright	Employee with Mortgage	Rented-Local Authority	Rented Private Owner	Rent Free	Average
Average Weekly Gross Income	£	39.19	49.63	34.82	35.44	24.50	40.22
Direct Taxes	%	7.0	12.6	10.8	13.9	9.1	9.8
of which:							
Income Tax	%	5.6	10.5	7.0	11.2	7.1	7.8
Social Insurance	%	1.4	2.1	3.8	2.7	2.0	2.0
Indirect Taxes	%	17.3	18.5	20.6	21.3	17.9	18.5
of which:							
Rates	%	1.8	2.5	2.2	4.3	0.4	2.3
Motor Taxation	%	0.6	0.7	0.4	0.6	0.9	0.6
VAT	%	5.3	5.8	5.8	5.4	6.1	5.5
Fiscal Duties	%	9.3	9.2	11.8	10.7	10.1	9.8
Licences	%	0.3	0.3	0.4	0.3	0.4	0.3
Total Taxation	%	24.3	31.1	31.4	35.2	27.0	28.3
Ratio of Final Income to Direct Income		.99	.87	1.15	.83	1.08	.96

25. Table 5.11 shows that gross income was above average where the householder was an owner-occupier with a mortgage and was below average in other cases. Despite having a relatively low average income, households in the private rented sector were the largest net contributors, after State taxes and benefits. The only net beneficiaries were households with rent free or local authority houses. Total taxation was below average where the accommodation was owned outright or rent free. Both direct and indirect taxes followed this pattern. Income tax paid by mortgage holders was less than that paid by the private rented sector despite the fact that income was 40 per cent higher in the former case. This may have reflected differences in dependency obligations between the two sectors and the fact that mortgage interest is allowed as a deduction for income tax purposes. Social insurance contributions bore most heavily on households in accommodation rented from local authorities. Rates bore most heavily on the private rented sector.

26. Due to the limitations of the Household Budget Survey information which has been presented, extreme caution must be exercised in using it as a base for any conclusions. The definition of income used is regressive in so far as certain items which are not included accrue more than proportionately to persons with higher incomes but it is difficult to quantify the effect of this. In addition, the household unit on which the Household Budget Survey is based is unsatisfactory for the purposes of taxation policy because it does not coincide with a unit which can be selected for tax purposes. The assumptions made about the incidence of taxation, particularly indirect taxation, are unrealistic.

APPENDIX 6

ESTIMATES OF INCOME EXEMPTED UNDER VARIOUS HEADINGS IN 1981/82

	£m
Married person's allowance	840
Single person's allowance	485
Widowed person's allowance	60
Single parent allowance	10.5
Child allowance	145
Nuptial allowance	2.5
Age allowance	8
Housekeeper allowance	1.5
Dependent relative allowance	12
Blind person's allowance	0.2
Allowance for employed person taking care of incapacitated individual	2.5
Age exemption	30
General exemption	118
Interest on personal borrowings (including mortgage interest)	147
Medical insurance premiums	18
Life assurance relief	27
Expenditure on residential premises (residence-related relief)	4.5
Health expenses relief	3
Deduction for Schedule E taxpayers	520
Premiums under permanent health benefit schemes	1
Loans to employees at preferential rate of interest	20*
Artists' relief	1.5**
Covenanted subscriptions	5

Source: Office of the Revenue Commissioners.

*The benefit has been taken to be the difference between the preferential rate and current commercial rate for personal borrowings.

**It is questionable whether this income would arise at all in the State in the absence of the relief.

APPENDIX 7

LOCAL AUTHORITY HOUSING

1. In this appendix we set out the present arrangements in relation to the schemes for fixing rents of local authority houses and for tenant purchase of these houses.

SCHEMES OF RENTS FOR LETTING LOCAL AUTHORITY HOUSES

2. In 1967, it was made a condition of State subsidy that all new lettings made by local authorities would be on an income-related basis and that dwellings at that time on fixed rent would be placed on a similar footing as soon as reasonably practicable.

3. On 31 March, 1974 31,586 dwellings (29 per cent) were let on fixed rents and 77,727 were let on differential rents. At 31 December, 1979 the number of dwellings let on fixed rents had declined to 12,357 (12 per cent), while the number let on differential rents had risen to 90,565.

Differential Rents

4. The rent payable under the differential rent scheme is calculated by the local authority concerned in accordance with criteria laid down by the Department of Environment in consultation with the Department of Finance, representatives of local authorities and the National Association of Tenants' Organisations.

5. The local authority national rents scheme for 1980 is as follows:

(a) Rents of dwellings let on differential rents are calculated on the assessable income of the principal earner, ranging from one-seventh to one-twentieth in accordance with a graded scale which includes allowances for the principal earner and dependent children.

(b) Assessable income of the *principal earner* is total income from the following sources, assessed *in full* for rent purposes but reduced by pay-related social insurance contributions and income tax where these are payable:

TABLE 7.1

Calculation of Differential Rents

Assessable income of principal earner £ per week		Principal earner's allowance £	Allowance for children £ per child	Rent fraction
over	not over			
	36	20	1.30	[illegible]
36	45	15	1.30	[illegible]
45	50	10	1.30	[illegible]
50	55	8	1.30	[illegible]
55		4	1.30	[illegible]

In the application of this scale, local authorities may make appropriate adjustments at the marginal points of the scale. After the rent payable in respect of the principal earner has been assessed, one-seventh of the income of each subsidiary earner which exceeds £14 and does not exceed £24.50 per week should be added (maximum addition for each subsidiary earner £1.50). The amount of rent calculated according to this scale cannot exceed the maximum rent set out in paragraph 7 or be less than the minimum rent set out in paragraph 8.

Maximum Rents

7. The annual maximum rent of a local authority dwelling cannot exceed 5.25 per cent of the original all-in-cost of the dwelling, up-dated to take account of inflation.

Minimum Rents

8. The minimum rent is 15 pence per week.

Fixed Rents

9. Fixed rents are increased by specified amounts from time to time. There is no uniform fixed rent scheme.

TENANT PURCHASE SCHEME FOR LOCAL AUTHORITY HOUSES

10. The following arrangements apply in relation to applications received from existing local authority tenants to purchase their houses in the two year period up to 31 January, 1983.

(i) basic income;

(ii) income from position as self-employed person;

(iii) all social welfare unemployment, pay-related and disability benefits, social welfare pensions, social assistance payments, redundancy weekly payments and AnCO training allowance (except payments listed in paragraph (f) hereunder), and

(iv) income from pensions other than social welfare pensions.

(c) The basic income of an employed person, in general, is the normal weekly rate of remuneration excluding overtime, shift allowances and bonus payments.

(d) The *principal earner* is the person who is either the tenant or the member of the tenants' family normally resident in the household who is in receipt of the highest income.

(e) A *subsidiary earner* is a member of the household, other than the principal earner, who has an income.

(f) The following are the main sources of income disregarded for the purposes of calculating rents:

(i) social welfare children's allowances;

(ii) scholarships;

(iii) disabled persons' maintenance allowance, domiciliary care allowance for handicapped children and infectious diseases maintenance allowance;

(iv) supplementary welfare allowances;

(v) allowances or assistance received from charitable organisations;

(vi) income from redundancy weekly payments, and

(vii) lump sum compensation payments.

(g) The allowance for children is £1.30 per week per child and applied to every child of 16 years or under or who being under 21, is attending a full-time course of education and is wholly or mainly maintained by the principal earner.

6. Differential rents are calculated on the basis set out in Table 7.1.

Terms

11. The sale price of a local authority house is calculated on the following basis:

(i) The gross price of the house is updated to May, 1981 money values by applying the Consumer Price Index to the original all-in-cost of the house.

(ii) A discount of 3 per cent for each year of tenancy is allowed subject to maxima of 30 per cent in built-up areas and 45 per cent in other areas.

(iii) A discount of £1,000 is allowed in lieu of the £1,000 new house grant payable to first-time owner-occupiers of certain new private houses. This discount is not given to any tenant who was at any time previously an owner-occupier.

(iv) A discount of £30 is allowed in respect of rates paid for each year of tenancy of a local authority dwelling up to 31 December, 1977 subject to a maximum discount of £300.

(v) The minimum sale price of a house shall not be less than £1,500.

APPENDIX 8

SAVINGS IN IRELAND: ECONOMIC BACKGROUND

1. In this appendix we examine the needs of the economy for savings, the existing data on savings in Ireland and the factors which may influence the aggregate level of savings. No convincing evidence has been produced to show that taxation has had a major effect on the aggregate level of savings.

Need for Savings

2. Savings are essential for investment which, in turn, is essential for the development of the Irish economy. In Ireland, the public and company sectors are the major promoters of investment. They are, however, net borrowers, their savings being less than their investment and the deficit has to be financed either by personal savings or foreign borrowing. The funds available from domestic sources are insufficient to finance the existing level of investment.

Economic Background

3. In an open economy, savings need not equal investment. Where investment is greater than savings, the balance must be borrowed abroad. This difference between savings and investment, which is reflected in foreign borrowing, is equal to the balance of payments deficit on current account. This is because the surplus on the capital account of the balance of payments must equal the current deficit. Therefore, the selection of the optimum gap between savings and investment is equivalent to a decision on the desired surplus or deficit on the balance of payments current account. It is generally considered that some of the investment needs of developing economies should be financed from abroad, provided the investment undertaken generates sufficient returns to repay the borrowings. Such a policy inevitably involves running a current deficit on the balance of payments. To the extent that domestic savings can be increased, foreign borrowing and the current deficit can be reduced.

4. The balance of payments deficit on current account in 1981 is estimated at about 13¾ per cent of gross domestic product. This may be indicative of excessive consumption and the need to increase savings substantially.

5. Importing capital from abroad increases real national income only if the return on capital in the domestic economy exceeds the real rate of interest at which the funds are borrowed abroad. In recent times there is evidence that the real rate of interest at which funds are borrowed has risen and that the productivity of capital has fallen. The latter is illustrated by the data in Table 8.1 which shows the relationship between investment and growth in the period from 1960 to 1980.

TABLE 8.1

Investment and Growth, 1960—1980.

Period Average	1961-65	1966-70	1971-75	1976-80
Investment (% of GDP)	18.8	20.8	23.8	27.8
GDP growth per Worker (%)	3.2	4.3	3.5	2.4
Incremental Capital Output Ratio	5.9	4.8	6.8	11.4

6. Despite a sharp and continuous rise in the investment ratio over the last twenty years, the rate of growth of output has failed to respond. As a consequence, the incremental capital output ratio has risen sharply. This ratio is simply the investment rate divided by the output growth rate. It gives a crude indication of the efficiency of investment. The data suggest that the rate of return on investment in Ireland has fallen. The investment rate in Ireland, at 30 per cent of gross domestic product, is high by international standards. Other countries with high investment rates have experienced much more rapid rates of output growth.

7. The inference to be drawn is that the level of investment is either too high to be sustainable, given the high cost of foreign borrowing, or that the composition of investment at the existing level is inappropriate, in that funds are being channelled into unremunerative projects in the public or private sectors. While the catalogue of unremunerative investments in the public sector is well-known, it is quite possible that the returns on real capital in the private sector are also low, given the heavy subsidisation of borrowing costs and the preference given to savings in certain institutional forms.

8. The data in relation to national savings shown in Table 8.2 are in historical cost terms. At current rates of inflation, they exaggerate the real position in the case of the personal sector. Very little work has been done internationally on inflation-adjusted savings ratios. Taylor and Threadgold[1] have prepared estimates of sectoral saving in the United Kingdom adjusted for the effects of price inflation on net monetary assets and liabilities. These

[1]C.T. Taylor and A.R. Threadgold, Bank of England, *'Real' National Saving and its Sectoral Composition*. Discussion Paper No. 6, 1979.

TABLE 8.2

National Savings 1970-1981

Year	Gross National Savings*	Personal Savings	Company Savings	Public Authority Savings	Personal Savings as % of Personal Disposable Income†
	£m	£m	£m	£m	%
1970	331.2	165.2	30.9	12.7	12.9
1971	373.5	170.2	43.3	23.1	11.9
1972	512.5	284.8	63.7	12.4	16.4
1973	645.1	410.6	106.0	−0.5	19.1
1974	590.6	475.4	85.1	−71.2	18.9
1975	825.1	833.7	96.3	−269.5	25.9
1976	981.3	824.1	174.0	−181.4	22.1
1977	1377.6	1003.9	270.9	−197.1	22.7
1978	1648.2	1242.7	279.4	−344.9	23.6
1979	1787	1418	332	−464	23.2
1980	1727	n.a.	n.a.	n.a.	n.a.
1981	1762	n.a.	n.a.	n.a.	n.a.

Source: National Income and Expenditure 1979 and earlier, Tables A.10 and A.8 and Department of Finance.

*Gross national savings are the total available for investment in domestic physical capital formation less net foreign disinvestment.

†The Central Bank of Ireland has estimated in its Annual Report for 1982 that the personal savings ratio fell below 21 per cent in 1980 and to below 19 per cent in 1981. It forecasts a further fall in the savings ratio in 1982, probably dropping below 18 per cent for the first time since 1972.

data were subsequently revised and are now published annually by the Bank of England.

9. The United Kingdom results are striking. Substantial inflation gains have accrued to the public sector as a large net debtor. On average, in the 1970's, while the nominal public sector financial deficit was equivalent to 4.3 per cent of national income, there was a positive balance of about 3 per cent of national income after inflation adjustment. The company sector as a whole also benefited from the effects of inflation on its net monetary liabilities, the gain to industrial and commercial companies more than offsetting the loss on net monetary assets of financial institutions. By contrast, the personal sector, as a large holder of net monetary assets, has incurred a persistent loss from the erosion of their real value. In the 1967-1979 period, nominal personal sector saving failed, on average, to compensate for the erosion of the real value of existing assets, so that the sector was dissaving in real terms.

10. It does not follow that the conclusions about real saving would be the same for Ireland. However, given the very high rates of inflation prevalent here in the last decade, it is likely that the inflation-adjusted figures would

show substantially lower personal savings and lower public authority dissavings. The effect on the company sector would depend on the relative magnitudes of the gearing and depreciation adjustments, which operate in opposite directions. The only conclusion that can be drawn is that the savings data in Table 8.2, which imply that savings in Ireland are high by international standards, are grossly misleading as a basis for policy decisions.

Determinants of Saving

11. There has been a considerable body of international research on the reasons for the increase in nominal saving and, in particular, into the causes of the sharp rise since 1973 which has been exhibited in a number of countries. This increase in nominal saving may be associated with a decline in real saving, but it is difficult to be sure, since international data on the level of real savings are poor. One explanation which has been offered is that the increase in uncertainty in the economic environment has been responsible. If people are fearful of their future prospects, they may choose to save more now as a safeguard. Another possibility is that unexpected inflation may have caused people to defer their purchases. While either of these explanations might account for a temporary upward movement in the saving ratio, neither is an adequate explanation for a persistent rise

12. One factor which may explain the sharp rise in saving is inflation itself. Some research suggests that saving is influenced by the level of wealth held by individuals and that inflation has acted to reduce the real value of holdings of financial assets. An increase in personal saving in response to this may be explained in one or both of the following ways. Firstly, the fall in weath may have caused people to feel poorer and so to have reduced their consumption. Secondly, some people may have been attempting to rebuild the ratio of wealth to income to something like its former level in order to have a command over real resources in the future comparable to that which they had before the inflation occurred. However, no convincing evidence has been produced to show that taxation has a major effect on the aggregate level of saving, though it may affect the distribution of savings among the various savings media.

APPENDIX 9

THE FIRST HOME MORTGAGE INTEREST REBATE IN NEW ZEALAND

1. In this appendix we describe the First Home Mortgage Interest Rebate Scheme which was introduced in New Zealand on 1 April, 1981. We consider that a scheme on these lines would be a superior method of encouraging owner-occupation to the existing general deduction for mortgage interest for tax purposes.

2. The rebate applies only in respect of first homes and is equal to 50 per cent of the amount of qualifying mortgage interest paid during an income year subject to a maximum annual rebate of $1,000. The rebate for any year cannot exceed the amount of tax payable for that year before allowance of the rebate.

3. The rebate is designed to cover the first five years of ownership of the first home. Two situations arise. In the case of first homes purchased on or after 1 April, 1976 and on or before 31 March, 1981, the rebate is related to the period still remaining after 31 March, 1981 which completes the first five years of ownership. In the case of first homes purchased on or after 1 April, 1981, generally, the first five complete years of ownership spans six income tax years. However, the rebate is limited to an overall maximum of $5,000 in those six income tax years.

4. If for any reason the first home is disposed of, no rebate is given for any unexpired portion of the five year period whether or not a subsequent home is acquired in that period.

APPENDIX 10

CAPITAL GAINS TAX

Scope of Tax

1. Any form of property (other than Irish currency) including an interest in property, wherever situated, is an asset for the purposes of capital gains tax. Disposal of an asset includes a transfer by a sale, exchange or gift of the asset and also the settlement of an asset on trustees. The receipt of a capital sum derived from assets, or received for forfeiture or surrender of rights, is regarded as a disposal. A disposal also includes a part disposal where less than the whole of an asset is disposed of.

Persons Chargeable

2. (i) All persons (including companies and trusts), who are domiciled and resident or ordinarily resident in the State are liable to capital gains tax (or, in the case of companies, to corporation tax) in respect of gains on the disposal of chargeable assets, wherever those assets are situated.

(ii) An individual, who is resident or ordinarily resident in the State but is not domiciled in the State is liable to tax on gains from the disposal of assets situated outside the State and the United Kingdom only to the extent that those gains are remitted to this country.

(iii) A person, who is neither resident nor ordinarily resident in this State, is liable to capital gains tax on gains from the disposal of

(a) land (including buildings) in the State,

(b) mineral assets in the State,

(c) rights in the Continental Shelf,

(d) shares deriving the greater part of their value directly or indirectly from the assets in (i), (ii) or (iii) (other than shares quoted on a stock exchange) and

(e) assets of a business carried on in the State.

Miscellaneous Exemptions and Reliefs

3. (i) The first £500 of an individual's net gains are not chargeable. In the case of a married couple living together the first £1,000 of net

gains are not chargeable. Where the net gains exceed £500, or £1,000 as the case may be only the excess over that figure is chargeable. The Finance Bill, 1982 proposes to increase these exemptions to £2,000 and £4,000 respectively.

(ii) A gain on the disposal by an individual of a dwelling-house (including grounds up to one acre) is generally exempt, if the house has been occupied as the individual's only (or main) residence during his period of ownership or occupied rent-free by a relative as his sole residence.

(iii) Where the proceeds of the sale of certain business assets are re-invested in replacement assets, the taxation of the gain made on the sale may be deferred, if the assets acquired in replacement continue to be used by the same person in the business.

(iv) Where an individual aged 55 years or over disposes of the whole or part of his business or farm or shares in his family company, which he has owned for at least ten years, he may claim total relief from tax if the disposal is within the family; if the disposal is made outside the family, and the consideration does not exceed £50,000, exemption may also be claimed.

(v) The following gains are not chargeable:

(a) bonuses payable under the national instalment savings scheme, prize bond winnings and gains from betting, lotteries and sweepstakes,

(b) gains on the disposal of Government securities, stocks of local authorities and securities issued by certain State-sponsored bodies,

(c) gains realised from life assurance policies and deferred annuity contracts,

(d) gains on the disposal, by an individual, of tangible movable property worth £2,000 or less at the time of disposal,

(e) gains on the disposal of wasting chattels of whatever value, as for example, animals, including bloodstock, and private motor cars, and

(f) gains accruing to superannuation funds, charities, and specified bodies such as local authorities, trade unions, etc.

Payment of the Tax

4. Capital gains tax is due and payable three months after the end of the year of assessment, that is, 6 July, or two months after the date of the assessment, whichever is the later. Interest on overdue tax is payable at the

same rate ($1\frac{1}{4}$ per cent per month) and in the same circumstances as interest on overdue income tax.

Inheritance

5. Where assets pass on death, there is normally no charge to capital gains tax and the person acquiring the assets is treated, in relation to a subsequent disposal of those assets, as if he had acquired them at their market value at the date of the death.

Tax Rates (reducing Rate Structure)

6. For any gains arising prior to 26 March, 1982, the basic rate of tax was 30 per cent but, subject to certain exceptions (for example, (a) all assets held by companies and (b) development land by whomsoever held), there was a reduction in this rate for every three years of ownership leading to total exemption after twenty-one years. The reduced rates of tax were:

Period of ownership of asset	Rate of Tax per cent
more than 3 years and not more than 6 years	25.5
more than 6 years and not more than 9 years	21.0
more than 9 years and not more than 12 years	16.5
more than 12 years and not more than 15 years	12.0
more than 15 years and not more than 18 years	7.5
more than 18 years and not more than 21 years	3.0

7. Proposals are included in the Finance Bill, 1982 to abolish tapering relief and to increase the normal rate of tax to 40 per cent. It is also proposed that nominal gains realised within one year of acquisition will be charged at 60 per cent and real gains realised within two or three years of acquisition at 50 per cent. A new special capital gains tax is being levied on disposals of development land. The tax rate will be 50 per cent, except in compulsory acquisition cases where it will be 40 per cent. Indexation relief will be allowed in respect of the then existing-use value on the date from which the gain is computed. Roll-over relief will not apply and losses on other disposals will not be allowed against development land gains. The proposed rates of tax for short-term gains will apply to all disposals of development land within three years of acquisition. The ordinary capital gains tax rates will apply to disposals of small sites.

APPENDIX 11

TREATMENT OF DEVELOPMENT GAINS IN OTHER COUNTRIES

1. In this appendix we set out the treatment of development gains in the United Kingdom, New Zealand and Canada which we have noted in our consideration of the issue.

United Kingdom

2. The Town and Country Planning Act, 1947 was the first of the post-war attempts to levy special taxes on development gains. The Act provided for the two-sided arrangement whereby a charge of 100 per cent was to be made on all development value arising in future and a lump sum (£300 million) was available for compensation for those with already established development value but no longer able to realise it. By general agreement the system did not work well and it was abolished in the early 1950's.

3. Between 1953 and 1962 there were no special land development taxes. In 1962, short-term gains were charged to income tax. These included gains made on assets (including land) disposed of within three years of acquisition. There was no separate provision for development land. In 1965, a general capital gains tax at 30 per cent was introduced. In 1967, certain changes were made in the taxation treatment of land with development value. The capital gains tax charge (30 per cent) was confined to the increase in the current use value of the land, and, in addition, there was a special levy, called betterment levy, at 40 per cent on the balance of the gain, that is, the development gain. The betterment levy differed in a number of significant ways from the 1947 arrangement: the charge was tied to the occurrence of development value rather than planning permission and it was now payable by the vendor (not the purchaser) at the rate of 40 per cent (not 100 per cent). The broad result was that capital gains arising out of development land were subject to betterment levy and those not involving change of use were charged to capital gains tax.

4. In 1970, the betterment levy was abolished and, for the next three years or so, development gains were charged to capital gains tax only. However, changes came in 1974. The great 1972 and 1973 property boom led to the introduction of development gains tax, essentially a means of subjecting

many types of development gains to normal income tax or corporation tax rates. In addition, some unrealised land gains, especially those arising on first lettings of buildings, were brought within the scope of capital gains tax. However, these arrangements had an even shorter life than their interim predecessors in that they were superseded by the Community Land Act, 1975 and the Development Land Tax Act, 1976. Development land tax was conceived of as a measure which would extract 80 per cent of development value on realisation or at the time of material development.

5. A reduced rate of 66⅔ per cent was allowed on smaller amounts of development value, i.e. amounts up to £150,000. The realised gain was chargeable under the ordinary rules but double taxation was avoided by deducting the amount chargeable to development land tax from the chargeable gain. In 1979, the tax was modified very substantially by increasing the exemption limit sharply (from £10,000 to £50,000), abolishing the dual rate structure and making the unified rate 60 per cent. The demise of the Community Land Act was announced and subsequently various other changes have been made such as the abolition of net of tax purchases by local authorities, advance assessment of tax liabilities, exemption of disposals by charities, proposals to charge applicants for planning permission for resultant public administrative costs and so on.

Basis of Charge

6. Development land tax is charged on the amount of development value realised on the disposal. This amount is measured by the excess of the net proceeds of disposal (broadly speaking, the consideration received less any incidental expenses) over whichever is the highest of three base values. The base values are:

Base A: the cost of acquiring the interest, together with any increase in its current use value over the period of ownership, and any expenditure on relevant improvements,

Base B: 115 per cent of the current use value of the interest at the date of disposal, together with any expenditure on relevant improvements,

Base C: 115 per cent of the sum of the cost of acquisition and expenditure on improvements.

Where Base A applies and the interest being disposed of was acquired before 1 May, 1977, the acquisition cost may be increased by a special addition; where a special addition is given on acquisition costs, the amount allowed as expenditure on relevant improvements may be correspondingly increased.

Death and Gifts

7. There is no disposal for development land tax purposes when an interest in land passes on the owner's death to his personal representatives.

On a subsequent disposal, the personal representatives have the same base values as would have been available to the deceased.

8. A gift of an interest in land is a disposal but, as there is no consideration, no development land tax liability arises on that occasion. If the donee subsequently disposes of the gifted interest, he may, in general, adopt any of the bases which would have been available to the donor.

Exemptions

9. Local authorities, certain other bodies which act in relation to land in a broadly similar manner to local authorities and charities are totally exempt from development land tax.

10. In addition to the exemption of the first £50,000 of development value realised in a financial year, disposals of certain types of interest are exempt, whenever acquired. These include an individual's private residence and not more than one residence occupied by a dependent relative. Development authorised by planning permission to win or work minerals is exempt. If a project of material development is started within 3 years of the acquisition of the interest in land on which the development takes place, development land tax is not chargeable provided that it can be shown that no significant amount of development value would have been realised had the project been commenced immediately after the acquisition. Development for agricultural purposes is not "material" development for the purposes of development land tax and thus is effectively outside the charge.

New Zealand

11. In New Zealand, the Property Speculation Tax Act, 1973 applies to dispositions of land in that country within two years of acquisition where the land is disposed of on or after 15 June, 1973. The tax may also apply to disposal of shares in close companies which are mainly land-owning or which are flat or office-owning companies. Disposals of residential land by owner-occupiers are exempt where there was no speculative intent in the acquisition and the land is sold because of circumstances arising since the acquisition and not principally to make a profit.

12. The tax is charged on the assessable profit which is generally the difference between the sale price and the cost price of the property plus or minus any receipts or expenditure not taken into account for income tax purposes, e.g. income such as rents and expenditure such as repairs and maintenance will be properly returnable for income tax purposes in the normal way.

13. The rates of the tax are as follows:

Period between acquisition and disposal	Rate of tax on assessable profit
6 months or less	90 per cent
6 and 9 months	85 per cent
9 and 12 months	80 per cent
12 and 15 months	75 per cent
15 and 18 months	70 per cent
18 and 21 months	65 per cent
21 and 24 months	60 per cent

No profit on disposal charged to property speculation tax is liable to income tax.

Canada

14. In Canada, where provincial Governments have power to levy taxes, a land speculation tax was imposed in Ontario in 1974. The tax was charged on the gains realised on the disposition of designated land situated in Ontario.

15. The rate of tax was 20 per cent of the increases in value of designated land disposed of after 9 April, 1974. There was, in certain circumstances, an additional tax of 20 per cent levied on the proceeds of disposition where control of a land-owning corporation was acquired by a non-resident.

16. In the case of property acquired after 9 April, 1974, the increase in value was generally the difference between the proceeds of disposition and the cost of acquisition, increased by expenditure incurred on acquisition and disposition and the cost of improvements. Fair market value at the date of acquisition was the starting figure for inherited property. In the case of property acquired before 10 April, 1974, the starting figure was generally the fair market value at 9 April, 1974. The tax was payable by the transferor of designated land at the time of disposition. This tax was repealed with effect from 24 October, 1978.

APPENDIX 12

RATES OF DIRECT TAXATION AND OF SOCIAL INSURANCE CONTRIBUTIONS AND BENEFITS IN IRELAND.

Section 1: Personal allowances under the income tax code.

Type of personal allowance	Amount in 1981/82	Amount in 1982/83	Cost in 1980/81
	£	£	£m
Single person	1,115	1,450	153.4
Married person	2,230	2,300	245.8
Widowed person	1,185	1,950	0.6
Additional allowance to widowed persons in year of spouse's death	1,045	950	0.7
Child allowance	195	100	42.6
Incapacitated child allowance	500	500	0.5
Age allowance (65 years or over) in respect of:			
—single person	80	100	
-married person	180	200	1.1
Allowance for one-parent families, where the parent is single	650	1,450	2.6
Allowance for one-parent families, where the parent is widowed	650	950	
Housekeeper allowance (for widow(er)) in respect of a housekeeper to care for children	165	Nil	0.6
Dependent relative allowance[2]	95	110	4.6
Blind person's allowance in respect of:			
– single person	400	500	
-married couple (both blind)	1,000	1,200	0.02
Additional allowance in year of marriage	115	Nil	0.7
Allowance for person employed to care for incapacitated individual	500	700	0.6
Employee allowance (for certain PAYE employments)	600	600	97.5
Exemption Limits[3] in respect of:			
–single or widowed person	2,000	2,200	18.6
– married person	4,000	4,400	

Type of personal allowance	Amount in 1981/82	Amount in 1982/83	Cost in[4] 1980/81
	£	£	£m
—single or widowed person (65 or over)	2,300	2,500	3.1
—married person (65 or over)	4,600	5,000	
single or widowed person (75 or over)	2,800	3,000	
married person (75 or over)	5,600	6,000	

Notes

1. The deduction for child allowance is reduced by £1 for each £1 by which the income of the child exceeds £80. No account is taken of income from scholarships or educational grants.

2. The income limit for dependent relative allowance is £1,922 in 1982/83. The allowance is reduced by £1 for each £1 by which the income of the relative exceeds the limit.

3. Where a taxpayer's net statutory income is more than the appropriate limit his tax liability cannot exceed 60 per cent of the difference between the limit and the amount of his income.

4. Estimated revenue foregone. The separate estimates for individual allowances cannot be simply added. If a number of the allowances were removed simultaneously, the taxpayers concerned might move into higher tax brackets, so that the revenue foregone would be underestimated by a simple addition of the estimates taken separately.

Section 2: Rates of income tax levied on the various slices of personal income remaining after the deduction of personal tax allowances.

Slice of Income after Allowances

Rates of Tax	Single persons		Married persons jointly assessed	
	1981/82	1982/83 Proposed	1981/82	1982/83 Proposed
%	£	£	£	£
25	1-1000	1-1,000	1-2,000	1-2,000
35	1,001-5,500	1,001-4,000	2,001-11,000	2,001- 8,000
45	5,001-7,500	4,001-6,000	11,001-15,000	8,000-12,000
55	7,501-9,500	6,001-8,000	15,001-19,000	12,001-16,000
60	Over 9,500	Over 8,000	Over 19,000	Over 16,000

Section 3: Social insurance contributions in 1982/83 must be paid in respect of all persons on earnings in any income tax year up to an income limit of £9,500. The rates of contribution vary for different classes of employees.

The ordinary rate of social insurance contributions for employees is 7.5 per cent in 1982/83.

Section 4: Weekly rates for certain principal social insurance benefits

	April, 1981	April, 1982
	£	£
Retirement Pension		
Couple	50.20	70.30
Single person	30.65	40.25
First child	7.00	8.30
Second child	7.00	9.20
Third to fifth child	5.80	7.65
Sixth and subsequent children	5.80	6.25
Disability and Unemployment Benefit		
Couple	40.45	52.15
Single person	24.55	31.65
First child	6.50	7.50
Second child	6.50	8.40
Third to fifth child	5.40	6.95
Sixth and subsequent children	5.40	5.55
Old Age Non-Contributory Pensioners (under 90)		
Couple	39.45	51.75
Single person	26.25	34.45
First child	6.25	7.30
Second child	6.25	8.20
Third to fifth child	4.85	6.40
Sixth and subsequent children	4.85	5.10
Unemployment Assistance (urban rate)		
Couple	35.10	45.20
Single person	20.40	26.20
First child	5.80	6.55
Second child	5.80	7.45
Third to fifth child	4.50	5.80
Sixth and subsequent children	4.50	4.65
Children's Allowances (monthly rate)		
First child	6.00*	11.25
Second to fifth child	9.00*	11.25
Sixth and subsequent children	9.00*	17.50

*July, 1981 rates.

APPENDIX 13

THE PURPOSE OF PERSONAL ALLOWANCES

1. There are basically two views about the purpose of personal income tax allowances or tax credits. The traditional view regards them as representing some notion of a minimum income level which should not be taxed. The second approach regards personal income tax allowances solely as part of the progressive structure of the tax system to ensure that there is horizontal equity between persons with the same income but different dependency and other obligations. The following paragraphs outline the views of previous Commissions and other authorities on this subject and set out the considerations involved.

Royal Commission on the Income Tax (1920)

2. Exemption limits were an early feature of the income tax code. The 1920 Royal Commission on the Income Tax suggested that

> "In its widest sense graduation included the question of the exemption limit" (para. 122).

On the specific issue of the exemption limit the Royal Commission had this to say:

> "The truth is that the exemption limit has never in this country been based on a figure consciously related to any kind of minimum of subsistence" (para. 244).

Royal Commission on the Taxation of Profits and Income (1951-1955)

3. The Royal Commission on the Taxation of Profits and Income in its second report published in 1954 pointed out that the two functions of the allowances — of exempting certain minimum incomes from tax and acting as an instrument of progression — were fundamentally in conflict:

> "The practice of looking to the personal allowances and earned income relief (since abolished) to provide effective exemptions has had the effect of distorting the tax structure at the lower end of the scale, in that the starting point of liability is lower than it could reasonably be

> expected to be if the needs of subsistence are borne in mind" (para. 161).

4. The Commission explained that this system of allowances could not act as an effective exemption limit without excessive cost in lost revenue. Whereas an exemption limit applied only to those at the bottom of the income scale, allowances are granted to taxpayers throughout the system. The cost of raising these allowances to maintain their value as an effective exemption is therefore very costly. The Commission proposed that a specific exemption limit be reintroduced to overcome this problem. Low-income groups could thereby be protected from the effects of inflation pushing them into the tax system, at a fraction of the cost involved in using allowances for this purpose.

Commission on Income Taxation (1957-1962)

5. The Irish Commission on Income Taxation in its Seventh Report acknowledges the effect that the allowances have in graduating the system:

> "Personal income taxation is graduated to make it correspond broadly with taxable capacity, taking into account the taxpayer's family and domestic responsibilities. Graduation is achieved by deducting certain allowances from each person's income in ascertaining the amount of it on which tax is to be charged". (para. 3).

It went on to say:

> "The personal allowances are in fact used in a rather indeterminate way to perform a double function, to provide a scale of effective exemption limits and also to provide some graduation in the tax payable by persons having incomes exceeding the effective exemption limits". (para. 23).

6. The Commission finally opted for the subsistence view of personal allowances:

> "In our view the personal allowances should provide effective exemption limits for each class of person, without the need for a formal exemption limit; and the effective exemption limits should be at least as high as subsistence expenses, but need not take into account all conventional or even unavoidable personal expenses". (para. 24).

On this basis, the Commission recommended that

> "the principle should be recognised that income tax should not be payable on the income needs for minimum subsistence". (para. 27).

7. The Government's reply to this recommendation was contained in the Second White Paper on Direct Taxation which stated that

"it has always been recognised that income tax should not be payable on the income needed for minimum subsistence". (para. 28).

The Royal Commission on Taxation in Canada (the Carter Commission)

8. The Carter Commission which reported in 1966 took the opposite view:

> "We have not tried to exclude from personal income tax an absolute amount that purports to be the income necessary to maintain a minimum standard of living. The idea that income taxes should not reduce income below 'subsistence' is laudable in its intention, but, we believe, misconceived. Subsistence has no absolute meaning. It is the relative positions of income and families that are important. Furthermore, neither exemptions from tax nor credits against tax can ensure that every Canadian has a minimum income. This objective can only be achieved through increased government transfer payments including, for example, refundable credits against taxes. The income tax system as such cannot be used to help people without income — those who most need help". (Vol. 3, p. 217).

Report of the Select Committee on the Tax Credit

9. This report which was published by the House of Commons in June, 1973 contained a number of questions to experts in its minutes of evidence. Amongst these the following question was put to Professor Brian Abel Smith of the London School of Economics:

> "Getting to this minimum expense of living . . . it has never been maintained that the tax allowances and family allowances should be enough to meet the minimum expenses of the family?" (Q. 1564, p. 362).

To which Professor Abel Smith replied:

> "It has not been maintained by any Government in this country because if they did they would have been forced to do it".

The Australian Taxation Review Committee (the Asprey Committee)

10. The Asprey Committee which reported in 1975 had this to say on the subject:

> "it may seem quite wrong and vertically inequitable to impose any significant income tax on very low incomes, and this points to a near-zero rate on such incomes, whatever the unwelcome implications

> for marginal rates higher up. In discussion of tax matters it is often suggested that this dilemma can be escaped by one or other of two devices. First, a universal personal allowance can be provided, as a deduction from taxable income, tax only being paid on what remains: the United Kingdom, the United States and Canada provide for a universal personal allowance. Or secondly, a non-reimbursable tax rebate can be given cancelling out the tax that would otherwise be paid at these levels: New Zealand has recently introduced a rebate along these lines. But these are in fact exactly equivalent to making the first step a zero-rate — and they mostly serve to conceal the abrupt rise in the effective marginal rate when, at the point of exhaustion of the allowance or the rebate, the marginal rate of the tax scale begins to be effective. Universal tax allowances or non-reimbursable tax rebates are merely techniques for altering the actual progressivity of the tax scale. It seems altogether simpler and less confusing to determine the progressivity of the income tax on its merits in the one obvious place: in the scale. The issue of the amount of tax to be levied on low incomes should not be obscured by artificialities". (para. 14.19).

The Committee added:

> "It seems essential to the Committee that decisions about the level of the first step, and the general shape of the rate scale for low income earners, should be made in the light of some clear understanding of the kinds of people it is who have these very low taxable incomes. That information is currently not available. But it is reasonable to suppose that they are persons who are realising capital or receiving exempt incomes from social services for only part of the year. And many others may be a statistical illusion arising from a person with more than one job preferring to appear as two persons to the Commissioner. At a time when the minimum wage is over $4,000 a year, it is clear that few could in fact survive on these lower incomes if the latter were a true measure of available resources for essential consumption".(para. 14.20).

11. Brendan Dowling in NESC Report No. 37, *Integrated Approaches to Personal Income Taxes and Transfers* concludes

> "in spite of the superficial resemblance between tax-free allowances and objective measures of poverty line income levels we must view the tax-free allowance structure as an integral part of the progressive income tax code, where the levels are determined independently of any view about minimum income levels" (para. 2.3).

APPENDIX 14

EQUIVALENCE RATIOS APPLIED OR PROPOSED IN VARIOUS COUNTRIES*

Country	Type (2)	Couple (3)	Single householder (4)	Child (5)	Scales	Couple + 2 children (6)
UK	(A) Supplementary Benefit (1975)	1.00 (a)	0.61	Age 0-4 Age 5-10 Age 11-12 Age 13-15 Age 16-28 Average	.17 .21 .26 .32 .38 .27	1.54
USA	(B) US Department of Health proposals	1.00 (b)	0.60	Age 0-4 Age 5 15 Age 16-18 Average	.15 .37 .52 .35	1.69
	(C) US Federal Government poverty measure (1974)	1.00 (b)	0.79		.25 (c)	
Australia	(D) Report of Commission of Inquiry into Poverty (1975)	1.00 (b)	0.61	Age 0-5 Age 6-14	.10 .17 (girl) .17 (boy)	1.38
				Age 15+ Average	.23 (girl) .27 (boy) .19	
Norway	(E) Bojer (1973)	1.00 (b)	0.58		.24 (d)	1.47

Source:
(A) Ordinary rate of supplementary benefit at November 1975.
(B) and (C). *The Measure of Poverty,* US Department of Health, Education and Welfare 1976.
(D) *Poverty in Australia,* First Report of the Commission of Inquiry into Poverty 1975.
(E) H. Bojer, *The Effect on Consumption of Household Size and Composition,* European Economic Review 9 (1977), pp 169-193.

APPENDIX 15

UNITED STATES SYSTEM OF AVERAGING

1. In this appendix we outline the system of averaging which operates in the United States.

2. **Computational Steps**
The computational steps are as follows:

(i) Compute "base period income" by determining the average income of the previous four years and multiply by 120 per cent.

(ii) Subtract "base period income" from current year income. The difference constitutes "excess income"; as long as it exceeds U.S.$ 3,000, this excess amount will be subject to averaging.

(iii) Compute tax liability on an amount of income equal to the "base period income" plus one-fifth of "excess income".

(iv) Compute tax liability on "base period income".

(v) Compute tax liability on "excess income" (line 3-line 4 × 5).

(vi) Compute tax liability for current year (line 4 + line 5).

2. Assuming 1981/82 income tax rates, a current year income of £20,000 and prior year incomes of £6,000, £7,000, £8,000 and £10,000 the operation of the above averaging system in the case of a married man, if operated in Ireland, would be as follows:

Step 1: Base period income: £6,000 + £7,000 + £8,000 + £10,000 = £31,000 × $\frac{1}{4}$ = £7,750 × 1.2 = £9,300.

Step 2: Excess income: £20,000 − £9,300 = £10,700.

Step 3: Tax on base period income of £9,300 + $\frac{1}{5}$ of £10,700 = £3,023.50.

Step 4: Tax on base period income of £9,300 = £2,274.50.

Step 5: Tax on excess income (step 3 — step 4) multiplied by 5 = £749 × 5 = £3,745.

Step 6:	Tax liability on current year income:	
	Tax on base period income of £9,300 (step 4)	£2,274.50
	Tax on excess income of £10,000 (step 5)	£3,745.00
		£6,019.50
	Tax liability with averaging	£6,019.50
	Tax liability without averaging	£6,973.50
	Saving	£ 954.00

APPENDIX 16

THE SOCIAL SECURITY SYSTEM

1. In this appendix we outline the main features of the social security system with particular reference to social insurance, health and redundancy contributions.

The Social Insurance System

2. The Department of Social Welfare administers schemes of social insurance and social assistance. Broadly speaking, the social insurance services are confined to employees and the social assistance services are available for self-employed and non-employed persons, for employees who fail for one reason or another to qualify for social insurance services and, in the case of children's allowances, on a universal basis.

3. Total expenditure on social welfare services, including the cost of administration, amounted to £1,206.6 million in 1981 and is estimated to amount to £1,576.8 million in 1982. Approximately 57 per cent of the cost is devoted to social insurance benefits. The balance refers to social assistance payments.

Historical Background

4. Social insurance in Ireland has its roots in the National Insurance Act, 1911. This Act consisted of two parts. The first part was concerned with the payment of sickness benefits, of a maternity benefit, of a disability pension and the right to treatment in a sanitorium. All workpeople over 16 and earning less than £160 a year were compulsorily insured, as were all manual labourers, irrespective of their earnings. The second part of the Act provided unemployment benefit to insured people in certain trades. All benefits and pensions provided under the Act were financed from contributions from the employees, employers and the State and were administered by non-profit making "approved societies". Thus by the time the State was established in 1922, the seeds of a social insurance system, albeit a limited one, had been sown. Since then the system has developed in a piecemeal fashion.

5. In 1935, the Widows' and Orphans' Pension Act introduced contrib-

utory pensions for the widows and orphans of wage earners. In 1942, the Insurance (Intermittent Unemployment) Act provided protection against loss of income due to bad weather for manual workers in the building, civil engineering and painting industries. In 1961, contributory old age pensions for men and women over 70 were introduced. In 1967, the occupational injuries insurance scheme came into operation and provided benefits to insured persons who suffer injuries in the course of their employment or who contract specified occupational diseases. The range of services was further extended with the introduction of retirement and invalidity pensions and death grants in 1970 and deserted wife's benefit in 1973.

6. In 1974, a number of important changes occurred. Subject to certain exemptions, compulsory insurance was extended to all employees of insurable age (16 years upwards) and a restricted pay-related benefit and contribution scheme was introduced. Up to 1974, all insurance contributions were flat-rate but under the new scheme pay-related contributions and pay-related benefits applied in the case of certain categories of workers only. When originally introduced, the pay-related benefit was payable for 26 weeks but it has been extended on a number of occasions since then and at present it may continue for up to 63½ weeks provided the relevant flat-rate benefit is also payable. In April 1979, a fully pay-related insurance contribution was introduced under which employees now pay a percentage of their income up to a set ceiling.

7. Up to 1933, the various social insurance schemes were administered by a large number of approved non-profit making insurance societies, under the general supervision of the Irish Insurance Commissioners. In 1933, the National Health Insurance Act made provision for the amalgamation of all these societies into a single body to be known as the National Health Insurance Society. In 1947, the Department of Social Welfare was set up and it was given complete responsibility for all social insurance and assistance functions. In 1950, the National Health Insurance Society was disbanded and its functions were placed under the control of the Minister for Social Welfare. The Social Welfare Act, 1952 created a unified social insurance scheme to replace the separate schemes for unemployment, national health and widows' and orphans' pensions which had operated up to then.

Present System of Social Insurance

8. Under the present social insurance system, employees are entitled to short-term benefits such as disability benefit, unemployment benefit, occupational injuries benefit, treatment benefit and maternity allowance, which includes a scheme of enhanced payments for women entitled to maternity leave under the Maternity (Protection of Employees) Act, 1981, in addition to the following long-term payments:

(i) Old age (contributory) pension,

(ii) Retirement pension,

(iii) Invalidity pension,

(iv) Widow's (contributory) pension,

(v) Deserted wife's benefit, and

(vi) Orphan's (contributory) allowance.

9. The system is a contributory one, benefits and pensions being paid out of the Social Insurance Fund, which is financed mainly by contributions from employers and employees, with the Exchequer meeting the short-fall between income and expenditure of the Fund each year. In recent years, the share of the cost of the benefits borne by the employers has increased significantly while that of employees and of the Exchequer has declined. The system is financed on the assessment or pay-as-you-go basis, which means that current contributions are used for the payment of current benefits.

10. The standard rate of contribution for 1982/83 is 19.11 per cent (including 1 per cent for youth employment levy, 1 per cent for health, 0.30 per cent for occupational injuries and 0.01 per cent for redundancy) of which 11.61 per cent is paid by the employer and is payable on any earnings up to a prescribed ceiling derived from any insurable employment. (See Para. 29) Contributions may be credited to an insured person in respect of any week of registered unemployment or certified incapacity for work.

11. Pensionable age in the social insurance system is at present 66 years, at which age liability for social insurance contributions ends and old age (contributory) pension is payable. Retirement pension is payable at age 65, subject to retirement from insurable employment. The obligation to retire does not apply to retirement pensioners after age 66. Invalidity pension is payable, without reference to age, to an insured person who is permanently incapable of work.

12. To qualify for pension, a person must satisfy the contribution conditions laid down for that pension. In the case of widow's (contributory) pension and deserted wife's benefit, the conditions may be fulfilled either on the husband's or the woman's own insurance, while the conditions for orphan's contributory allowance may be fulfilled on the insurance of either parent or of a step-parent of the orphan. All pensions are flat-rate and consist of a personal rate for the pensioner and, where appropriate, flat-rate additional payments for dependants.

13. Since the abolition of the remuneration limit on 1 April, 1974, the

social insurance system covers practically the whole of the employee field. Social insurance is compulsory within that field for persons between the ages of 16 and 66 but there is provision in the system to modify the insurance coverage so that certain types of employment may be relieved from full insurance and covered only for the benefits considered to be necessary for persons in those employments. The employments concerned are mainly in what could be regarded broadly as the public sector, namely.

(i) established civil servants,

(ii) commissioned officers in the defence forces and members of the army nursing service,

(iii) permanent and pensionable employees of local and public authorities and statutory transport undertakings,

(iv) pensionable teachers in national schools, secondary schools, comprehensive schools, teacher training colleges and domestic science training colleges,

(v) permanent and pensionable employees of voluntary hospitals or voluntary organisations providing district nursing services where there is adequate provision for payment during illness, and

(vi) members of the Garda Síochána.

This power to modify has been used to limit social insurance coverage of permanent and pensionable employees in the public sector and a special rate of contribution is payable by persons in these employments which covers them for widow's (contributory) pension, deserted wife's benefit and orphan's (contributory) allowance but not for the other pensions.

14. The largest group of working people excluded from social insurance cover is the self-employed, including 160,000 farmers. (They can avail themselves of the social assistance services if they satisfy the means test). Doctors and dentists, whether self-employed or not, are also excluded. The continued exclusion of the self-employed has been due, among other factors to the high level of contribution which could be required, in the absence of an employer's share, from an individual self-employed person, and to the difficulties and costs involved in collecting such a contribution. In 1978, the Department of Social Welfare issued a discussion paper in which the problems and prospects of devising a social insurance scheme for the self-employed were aired. No further action has been taken on the matter to-date.

15. Apart from the self-employed, other groups of people are also excepted from social insurance. Persons aged under 16 years and over 66 are not insurable, except for occupational injuries. Normally, religious are also excepted from insurance. However, a representative authority may

apply on behalf of a class of persons in religion to have such class of persons who are employed as ministers of religion admitted into social insurance. Church of Ireland clergymen so employed have in this way been brought into the social insurance scheme. Finally, those outside the labour force, including 182,000 students and 640,000 housewives, are not eligible for social insurance in their own right, although they may benefit as dependants of an insured person.[1]

16. Certain other employments are also excluded from social insurance cover. These are:

(i) Employment by one's husband or wife, and

(ii) Employment by a prescribed member of the immediate family from the same household where the work is in the house or on a farm, where both employer and employee live.

The following employments are insurable for occupational injuries benefits only.

(i) Casual employment in or about the employer's residence.

(ii) Subsidiary employment as specified in regulations where it is not the principal means of livelihood, for example, employment as a polling clerk at elections or part-time employment as a school cleaner.

(iii) Employment specified as being of inconsiderable extent. This is defined as employment for less than eighteen hours per week where the employee is not mainly dependent on the earnings from the job. A married person who works for only a few hours a week and who is mainly supported by his/her spouse is an example of this kind of employment.

(iv) Employment under contract of service as a doctor or dentist.

Contribution Conditions

17. The contribution conditions require a claimant to insurance benefits or pensions to have a certain standard of insurance in order to qualify for payment. An insured person must have a minimum number of contribution

---

[1] Such persons may benefit indirectly as dependants of insured persons in that the insured persons may claim increases of any of the benefits or pensions for which they have cover in respect of their dependants. The right to payment lies with the insured person. However, housewives and students may qualify in their own right for widow's (contributory) allowance, deserted wife's benefit or orphan's (contributory) allowances on the basis of contributions paid by the husbands or the parents as appropriate.

weeks for which the appropriate employment contributions have been paid or credited in each contribution year in order to preserve title to insurance payments. Entitlement to the maximum rate of benefit usually depends on having at least 48 contribution weeks in each contribution year.

18. If an insured person has less than 26 contribution weeks in a contribution year, they cannot qualify for unemployment, disability, maternity or treatment benefits throughout the whole of the following benefit year. Pension entitlement is determined by reference to the average number of contribution weeks over a defined period so that a shortage of weeks in one year may be made up by a surplus in other years. There are no contribution conditions for the award of occupational injuries benefit or pay-related benefit.

19. Credited contributions are allowed automatically for weeks in respect of which an insured person received disability benefit, unemployment benefit, maternity allowance, invalidity pension or retirement pension. Similarly, credited contributions may be allowed for weeks in respect of which an insured person received injury benefit or unemployment assistance. An insured person who is incapable of work or genuinely unemployed can obtain credited contributions even if they do not qualify for the payments mentioned earlier. In order to obtain these credited contributions however, it is essential for a person to send to the Department of Social Welfare regular medical evidence while illness lasts or to sign the unemployed register at the times and place appointed by the local office, for as long as unemployment lasts.

20. The contribution conditions for the various benefits are summarised in Table 16.1.

21. The contribution conditions for the remaining social insurance benefits are summarised in Table 16.2.

22. A person who has paid social insurance compulsorily for not less than three years may, if he ceases to be compulsorily insured, maintain and improve the pension rights he had acquired by paying voluntary contributions. The rate of voluntary contribution payable will depend on whether the compulsory insurance had been at the full rate or modified rate of contribution only.

Financing of Social Insurance Services

23. The general social insurance services are financed through the Social Insurance Fund, which is funded on a tri-partite basis by employers, employees and the Exchequer. By far the largest part of Fund income is the

TABLE 16.1.

Contribution Conditions for Social Insurance Benefits

Benefit	Minimum number of *paid* contribution weeks required since employment commenced	Number of contribution weeks paid or credited required in last complete contribution year before the beginning of benefit year in which claim is made		Number of weeks of insurable employment required to requalify for benefit	Duration of payment of benefit
		Min.	Max.		
Unemployment Benefit	26	26	48	13	390 days 312 days 156 days
Disability Benefit	156	26	48	—	Indefinitely to age 66
	26-156	26	48	13 required or 156 contributions if less	52 weeks
Treatment Benefit					
Under 21	26	—	—	—	Related to cost of treatment
21-23	26	26	26		
23 and over	156	26	26	—	
Maternity Allowance	26	26	26	—	12 weeks
Maternity Grant	26	26	26	—	
Invalidity Pension	156	48	48	—	Indefinitely while in retirement or permanently incapable of work
Death Grant	26	26*	48*	—	—
Pay-Related Benefit†				—	

*Or average since date of entry into insurance

†This is a supplement to flat-rate disability benefit, unemployment benefit and maternity allowance. The relevant contribution conditions apply.

TABLE 16.2

Contribution Conditions for Social Insurance Benefits

Benefit	Minimum number of paid contribution weeks required after employment commenced	Average number of contribution weeks paid or credited			
		Since entry into insurance		(1) In the contribution year or financial year 3 years before death, desertion or attaining pension age	
		Min.	Max	Min.	Max
Contributory Widow's Pension	156 before husband's death	24	48	39	39
[illegible] Allowance	26				
[illegible]	[illegible] desertion	24	48	39	39
Retirement Pension	156	24	48	Insurance must be entered before age 55.	
Contributory Old Age Pension	156	20	48	Insurance must be entered before age 56.	

revenue from the social insurance contributions of employers and employees. The other main item of Fund income is the Exchequer contribution. The balance of the Fund's revenue comes mainly from income from investments. The sources of income of the Social Insurance Fund are shown in Table 16.3.

TABLE 16.3

Sources of Income of the Social Insurance Fund

	1981		1982 (estimate)	
	£m	%	£m	%
Employer	342.0	49.6	448.00	51.3
Employee	135.5	19.7	205.15	23.5
Exchequer	210.5	30.5	218.67	25.0
Other sources	1.6	0.2	1.38	0.2
Totals	689.6	100.0	873.2	100.0

24. The sources of income of the Occupational Injuries Fund are as shown in Table 16.4

TABLE 16.4

Sources of Income of the Occupational Injuries Fund

	1981		1982 (estimate)	
	£m	%	£m	%
Employer	12.0	87.6	15.2	89.4
Other sources	1.7	12.4	1.8	10.6
Totals	13.7	100.0	17.0	100.0

25. The sources of income of the Supplementary Unemployment (Wet Time) Fund are shown in Table 16.5.

TABLE 16.5

Sources of Income of the Supplementary Unemployment (Wet Time) Fund

	1981		1982 (estimate)	
	£m	%	£m	%
Employer	0·90	50	0·90	50
Employee	0.90	50	0.90	50
Totals	1.80	100	1.80	100

Social Assistance Services

26. The social assistance services, including children's allowances, are almost wholly financed by the Exchequer directly, only a small amount being provided by local authorities. The financing of these services is shown in Table 16.6.

TABLE 16.6

Financing of Social Assistance Services

	1981		1982 (estimate)	
	£m	%	£m	%
Exchequer	490.4	97.8	671.8	98.1
Local Authorities	10.3	2.0	12.1	1.8
Other sources	0.8	0.2	0.9	0.1
Totals	501.5	100.0	684.8	100.0

Overall position

27. The total cost of social welfare services broken down by source of income is shown in Table 16.7.

TABLE 16.7

Financing of All Social Welfare Services

Source	1981		1982	
	£m	%	£m	%
Employers	354.9	29.4	464.1	29.4
Employees	136.4	11.3	206.0	13.1
Exchequer	700.9	58.1	890.5	56.5
Local Authorities	12.1	1.0	12.1	0.7
Other sources	2.3	0.2	4.1	0.3
Totals	1,206.6	100.0	1,576.8	100.0

Collection of Contributions

28. Since 6 April, 1979, a system of fully pay-related social insurance contributions (PRSI) has operated. These contributions from employers and employees are, for the vast majority of employees, collected by the Revenue Commissioners through the PAYE system of income tax collection. For the small minority of employees not on the PAYE system and for voluntary contributors, contributions are collected directly by the Department of Social Welfare. In addition to collection of PRSI contributions, the PAYE system is used for the collection of information on the duration of each employee's insurable employment on which entitlement to benefit depends, and on his reckonable earnings which are used in calculating his entitlement to pay-related benefit.

29. Under this system, PRSI contributions are payable as a percentage of each employee's income up to a ceiling in each income tax year—the ceiling being £8,500 in 1981/82 and £9,500 in 1982/83. The percentage rate of contribution payable depends on the class in which the employee is insured. There are twelve different classes each with a special rate of contribution. The 1 per cent youth employment levy which is included in the PRSI contribution from April, 1982 is on *all* income and is not subject to a ceiling.

30. The supplementary unemployment or "Wet Time" insurance contribution, which applies only in the building, civil engineering and painting trades is still collected directly by the Department of Social Welfare by means of stamped insurance cards. The PAYE system is now the main system for the collection of both contribution income and data for insurance records purposes under the social insurance system including occupational injuries insurance.

Redundancy Contributions

31. The Redundancy Payments Acts administered by the Department of

Labour provide that certain insured workers who lose their jobs through redundancy will, if certain requirements are met, get a lump sum payment. (Up to 1979 they also provided for weekly redundancy payments). The lump sum payment is related to years of service and subject to an earnings ceiling. It is paid by the employer who normally gets a partial rebate from the Redundancy Fund. This fund used to be financed by employers' and employees' contributions. Following the 1979 Redundancy Payments Act the employees' contributions were abolished as also were the weekly redundancy payments.

Tax relief for Social Insurance Contributions

32. Prior to 1979, the amount of any employees' contribution under the Social Welfare Acts which was determined by the Minister for Social Welfare to be referable to widow's (contributory) pension, orphan's (contributory) allowance, retirement pension, old age (contributory) pension and death grant was allowed as a deduction from income for income tax purposes. These benefits, with the exception of death grant, were chargeable to tax and the allowance was justified on the grounds that to charge the benefits and not to allow the contribution which went to secure them would constitute double taxation.

33. Prior to 1979, the tax allowance in respect of social insurance contributions was the same for identifiable classes of taxpayers. With the change to fully pay-related contributions in 1979, the deduction would vary with income, which would make it very difficult for employers to give effect to it. For this reason, it was decided that direct tax relief would not be given in respect of any part of the pay-related social insurance contribution. However, the saving to the Exchequer from not allowing relief on that part of the contribution referable to benefits which are chargeable to tax was taken into account in determining the rate of contribution, thereby indirectly providing the appropriate relief in the aggregate.

34. On 22 April, 1982, the Government announced that it proposed to introduce a special income tax allowance of £312 to be granted in 1982/83 to all employees liable at the standard rate of social insurance contributions. No allowance is being granted to those liable at lower rates of contribution.

APPENDIX 17

COMPANY TAXATION IN IRELAND

1. In this appendix we describe the historical development of the present system of company taxation in Ireland. We also outline the main incentive reliefs which now exist.

Historical Note

2. The system of company taxation, in its essentials, remained unchanged between 1922 and 1976. Under that system, companies were charged to two taxes on their profits — income tax and corporation profits tax — although the basis of the charge was not precisely the same for each of these taxes. The combined effective rate in 1975 was 50 per cent approximately.

3. The Commission on Income Taxation made certain recommendations in its Sixth Report[1] in relation to company taxation. These included the following:

(i) Corporation profits tax should be closely associated with company income tax both in assessment and collection, and

(ii) Company income tax should be charged on the income of accounting periods instead of fiscal years.

In its Seventh Report,[2] the Commission considered the separation of company and personal taxation and concluded that it did not favour a scheme of company taxation involving double taxation of that part of company income which is distributed to shareholders.

4. Following the Commission's reports, the question of the separation of company and personal taxation remained dormant until the publication of a White Paper "Company Taxation in Ireland" in November, 1972.[3] The White Paper proposed that the taxation of companies be rationalised by the introduction of a single corporation tax at a rate of 50 per cent in place of the dual system of income tax and corporation profits tax which gave rise to a combined effective rate of almost 50 per cent. The tax system proposed

[1]Sixth Report, Prl. 6039, 1961.
[2]Seventh Report, Prl. 6581, 1962.
[3]Prl. 2628.

was an imputation system. Under this system, on payment of dividends, it was proposed that an amount equivalent to the tax to be imputed to shareholders would be paid to the Revenue Commissioners. This would represent for the company an advance payment on account of its corporation tax liability for the accounting period in which the dividends were paid. The White Paper invited interested persons to make known their views about these proposals.

5. Following a period of consultation, a second White Paper "Proposals for Corporation Tax" was published in March, 1974.[4] This contained a decision by the Government to introduce a single corporation tax in place of income tax and corporation profits tax on company profits. The proposal to introduce an advance payment of corporation tax on payment of dividends was rejected on the grounds that it would have an adverse effect on cash flow and reduce the funds available for investment in new machinery and plant.

6. The Corporation Tax Act, 1976 enacted the remaining proposals contained in the Second White Paper, and this forms the basis of the existing system of corporation tax.

Incentive Reliefs

7. A basic objective of Irish economic policy since 1922 has been to set in motion and sustain a rate of economic development which would achieve a rate of employment-creation leading to the elimination of involuntary emigration and the reduction of unemployment. It became clear that, in the circumstances in which the Irish economy was placed, these aims could be achieved only through industrialisation. Incentives and inducements to stimulate industrial investment became a feature of economic policy.

8. Tax relief for profits from exports was introduced in 1956. The effect of the relief originally was that for a five-year period the tax on profits from new export sales of manufactured goods (or from an increase in export sales of such goods over the sales in a standard period) would be reduced by 50 per cent. In 1957, the rate of relief was increased to 100 per cent and, in 1958, the number of years for which relief was available was increased from five to ten. Further improvements were made between 1960 and 1969 and the present position is that profits of a company which exported qualifying goods before 1 January, 1981 obtain full relief for up to fifteen years and partial relief for an additional period of up to five years. Companies which did not begin to export goods prior to 1 January, 1981 do not qualify for export sales relief, unless they received a written assurance from a person duly authorised by the Minister for Finance to the effect that

[4]Prl. 3713.

the company should qualify and fulfilled certain conditions during 1981. The relief is due to expire on 5 April, 1990.

9. With effect from 1958, the profits of a company from certain "exempted trading operations" carried on in the customs-free area of Shannon Airport were exempt from tax. Like export sales relief, this exemption ceased with effect from 1 January, 1981, except in the case of trading operations exempted before that date, or trading operations commencing after that date in respect of which an assurance had been given before 1 January, 1981, by a person authorised by the Minister for Finance, that the trading operations would be regarded as exempted, in which cases the exemption may continue until 1990. Exempted trading operations include

(i) export sales of goods produced, manufactured or processed in the airport;

(ii) export sales of imported goods;

(iii) the rendering of services relating to the use of aircraft, and

(iv) other trading operations which contribute to the use or development of the airport.

10. With effect from 1 January, 1981 until 31 December, 2000, a company which has profits from sales (whether export or domestic) of goods which it has itself manufactured within the State or from the provision, within the State, of a manufacturing service, may claim relief from corporation tax, such that the effective rate of corporation tax on those profits will not exceed 10 per cent. This new relief replaces export sales relief and Shannon relief which terminated on 31 December, 1980, subject to certain exceptions, as outlined in paragraphs 8 and 9 above. The corporation tax referable to a company's sales of manufactured goods is, broadly speaking, determined by reference to the proportion which its receipts from sales of manufactured goods bears to its total sales. The new relief extends also to profits from certain service activities carried on at Shannon Airport, profits from sales of mushrooms cultivated within the State and fish produced on a fish farm within the State, profits from the provision within the State of a service of repairing ships and profits from the provision within the State of design and planning services connected with engineering works executed outside the territories of the member States of the European Community.

11. Distributions treated as having been made out of profits which have been granted the new relief (that is, effectively charged at a rate not exceeding 10 per cent) are liable to income tax in the hands of resident non-corporate shareholders subject to a tax credit of one-eighteenth of the distribution. The lower rate of tax credit also applies on the redistribution by a company of distributions carrying the tax credit of one-eighteenth which are received by it from another company.

APPENDIX 18

STATEMENT OF STANDARD ACCOUNTING PRACTICE NO. 16 (Part 3)

Introduction

In this appendix we reproduce Part 3 of the Statement of Standard Accounting Practice No. 16 issued by the Accounting Standards Committee on Current Cost Accounting.

Scope

"46. This standard applies to all annual financial statements intended to give a true and fair view of the financial position and profit and loss other than those of entities falling within the categories listed below:

(a) entities which do not have any class of share or loan capital listed on The Stock Exchange and satisfy at least two of the following three criteria:

(i) they have a turnover of less than £5,000,000 per annum;

(ii) their balance sheet total** at the commencement of the relevant accounting period is less than £2,500,000 as shown in the historical cost accounts; and

(iii) the average number of their employees in the United Kingdom (UK entities) or in the Republic of Ireland (Republic of Ireland entities) is less than 250;

(b) wholly owned subsidiaries of companies or other entities where the parent is registered in the UK or Republic of Ireland. This exemption does not apply where the parent is exempted under (c) or (d) below;

(c) (i) authorised insurers,

(ii) property investment and dealing entities, with the exception of such entities as hold the properties of another entity within the group to which this standard does apply; and

(iii) investment trust companies, unit trusts and other similar long term investment entities; and

(d) entities whose long term primary financial objective is other than to achieve an opeating profit (before interest on borrowing); such entities may include charities, building societies, friendly societies, trade unions and pension funds.

Where an entity exempted under (c) or (d) above has subsidiaries which are not themselves exempted under these sections and which collectively exceed the limit in (a) above, the group accounts should include consolidated current cost information in respect of such subsidiaries.

47. Annual financial statements of entities coming within the scope of the standard should include, in addition to historical cost accounts or historical cost information, current cost accounts prepared in accordance with this standard. The current cost accounts should contain a profit and loss account and balance sheet, together with explanatory notes, disclosing the information set out in paragraphs 55-59.

48. This requirement to include current cost accounts in addition to historical cost accounts or historical cost information can be complied with by:

(a) presenting historical cost accounts as the main accounts with supplementary current cost accounts which are prominently displayed; or

(b) presenting current cost accounts as the main accounts with supplementary historical cost accounts; or

(c) presenting current cost accounts as the only accounts accompanied by adequate historical cost information. The historical cost disclosure requirements will be clarified when the EEC Fourth Directive is enacted in UK/Irish law. Meanwhile, an entity preparing current cost accounts as its only accounts should provide at least sufficient information to enable the user to ascertain the historical cost profit of the period under existing conventions.

The current cost profit and loss account

49. The current cost operating profit* is derived by making the following main adjustments to the historical cost trading profit (before interest on net borrowing*) to allow for the impact of price changes on the funds needed to maintain the net operating assets*:

(a) in relation to fixed assets, a depreciation adjustment being the difference between the proportion of their value to the business* consumed in the period and the depreciation calculated on the historical cost basis:

(b) in relation to working capital:

(i) a cost of sales adjustment being the difference between the value to the business and the historical cost of stock consumed in the period; and

(ii) an adjustment based on monetary working capital*.

50. Where a proportion of the net operating assets is financed by net borrowing, a gearing adjustment is required in arriving at the current cost profit attributable to the shareholders. This should be calculated by:

(a) expressing net borrowing as a proportion of the net operating assets using average figures for the year from the current cost balance sheets; and

(b) multiplying the total of the charges or credits made to allow for the impact of the price changes on the net operating assets of the business by the proportion determined at (a).

This adjustment, normally a credit, could be a debit if prices fall.

51. No gearing adjustment should be made in the profit and loss accounts of Nationalised Industries in view of the special nature of their capital structure. Accordingly, in such cases interest on their net borrowing should be shown after taxation and extraordinary items.

52. The treatment within the current cost profit and loss account of gains and losses on asset disposals, extraordinary and exceptional items, prior year items, income from associates, group consolidation adjustments, minority interests and the translation of foreign currencies, should where practicable, be consistent with the definitions of profit set out in this standard. Where this is impracticable the treatment adopted should be disclosed in a note to the current cost accounts.

The current cost balance sheet

53. Assets and liabilities should be included in the balance sheet, as far as practicable, on the following bases:

(a) *Land and Buildings, plant and machinery and stocks subject to a cost of sales adjustment* — at their value to the business.

(b) *Investments in associated companies* — either at the applicable proportion of the associated companies' net assets stated under this standard or, where such information is not readily available, at directors' best estimate thereof. Allowance for premium or discount on acquisition should be made as stated under (e) below.

(c) *Other investments (excluding those treated as current assets)* — at direc-

tors' valuation. Where the investment is listed and the directors' valuation is materially different from mid-market value, the basis of valuation and the reasons for the difference should be stated.

(d) *Intangible assets (excluding goodwill)* — at the best estimate of their value to the business.

(e) *Goodwill (premium or discount) arising on consolidation* — on the basis set out in SSAP 14.[1] Where goodwill is carried at an amount established before the introduction of SSAP 14 it should be reduced to the extent that it represents revaluation surpluses relating to assets held at the date of the acquisition.

(f) *Current assets, other than those subject to a cost of sales adjustment* — on the historical cost basis.

(g) *All liabilities* — on the historical cost basis.

54. Reserves in the current cost balance sheet should include revaluation surpluses or deficits and adjustments made to allow for the impact of price changes in arriving at current cost profit attributable to shareholders. Amounts to reduce assets from net current replacement cost to recoverable amount* should be charged to the profit and loss account.

Contents of accounts

Profit and loss accounts

55. The current cost profit and loss account should show (not necessarily in this order):

(a) the current cost operating profit or loss;

(b) interest/income relating to the net borrowing on which the gearing adjustment has been based;

(c) the gearing adjustment;

(d) taxation;

(e) extraordinary items; and

(f) current cost profit or loss (after tax) attributable to shareholders.

56. A reconciliation should be provided betweent the current cost operating profit and the profit or loss before charging interest and taxation calculated on the historical cost basis giving the respective amounts of the following:

(a) depreciation adjustment;

[1]SSAP 14—Group Accounts—Statement of Standard Accounting Practice.

(b) cost of sales adjustment;

(c) monetary working capital adjustment and, where appropriate, interest relating to monetary working capital; and

(d) other material adjustments made to profits calculated on the historical cost basis when determining current cost operating profit.

The adjustments for cost of sales and monetary working capital may be combined.

Balance sheet

57. The current cost balance sheet (which may be in summarised form when a full historical cost balance sheet is disclosed) should show the assets and liabilities of the entity on the bases required by this standard. Notes to the balance sheet should disclose the totals of net operating assets and net borrowing and their main elements. The balance sheet should be supported by summaries of the fixed asset accounts and the movements on reserves.

Notes to the accounts

58. The notes attached to the current cost accounts should describe the bases and methods adopted in preparing the accounts particularly in relation to:

(a) the value to the business of fixed assets and the depreciation thereon;

(b) the value to the business of stock and work in progress and the cost of sales adjustment;

(c) the monetary working capital adjustment;

(d) the gearing adjustment;

(e) the basis of translating foreign currencies and dealing with translation differences;

(f) other material adjustments to the historical cost information; and

(g) the corresponding amounts.

Earnings per share

59. Listed companies should show the current cost earnings per share based on the current cost profit attributable to equity shareholders before extraordinary items.

Group accounts

60. A company which is the parent company of a group and which is required to produce current cost group accounts should produce such group accounts in accordance with the principles set out in this standard. It need not however produce current cost accounts for itself as a single company where historical cost accounts are the main accounts.

Corresponding amounts

61. In all accounts prepared in accordance with this standard corresponding amounts for the preceding period should be stated. However unless current cost accounts are the main accounts corresponding amounts need only be included for the first period for which current cost accounts are prepared if they are readily available.

Relationship with other standards

62. Existing standards issued for use with historical cost accounts apply to current cost accounts except where a conflict exists caused by the conceptual difference between the systems. The four fundamental accounting concepts in SSAP 2 should be observed and information on accounting policies should be given. The source and application of funds statement required by SSAP 10 should be compatible with the main accounts.

Date from which effective

63. The accounting practices set out in this standard should be adopted as soon as possible. They should be regarded as standard for annual financial statements relating to accounting periods starting on or after 1st January 1980".

*As defined in the definitions section of the standard.

**For the purposes of this paragraph, the balance sheet total is defined as the total of the followings assets:

Fixed assets (net book value) other than investments
Investments
Current assets including prepayments and accrued income (before deduction of current liabilities).

APPENDIX 19

CURRENT PURCHASING POWER ACCOUNTING

1. In this appendix we set out the principles of current purchasing power accounting, examine its development and illustrate how it would be operated in practice.

The Principles of Current Purchasing Power Accounting

2. Current purchasing power (CPP) accounts focus on the change in the general purchasing power of money over a period as reflected by the change in the Consumer Price Index. Prior year figures and transactions during a period are translated into common units of purchasing power and gains or losses on holding monetary assets or liabilities are taken to the profit and loss account. Accounts restated in CPP terms are intended to show the extent to which the purchasing power, which the shareholders have invested in a business, has been maintained over a period.

3. The purchasing power method of inflation accounting is based on the assumption that the most significant problem arising for the preparation of accounts during a period of high inflation is that the conventional unit of measurement — money — becomes unstable and changes in value too rapidly to be useful as a unit of measurement. The central feature of the purchasing power method is the adoption of a different unit of measurement — the "purchasing power unit" — in place of the monetary unit. The objective of the method is to enable accounts during a time of changing prices to be expressed in a unit of measurement which has a constant value, and is therefore more useful than the monetary unit. Thus it is suggested that the balance sheet should show the amount of "purchasing power" represented by the company's net assets rather than the amount of money; and that the profit and loss account should show the amount of "purchasing power" gained or lost during the year.

4. Because CPP accounting is concerned with showing the effect of activities during the accounting period on the purchasing power of the equity of the shareholders or proprietors, it uses an index of the change in the power of money to purchase commodities of the type that consumers in general buy. The Consumer Price Index is widely regarded as the best

available indicator of changes in the general purchasing power of money to consumers and would, therefore, be the most appropriate index for the preparation of CPP accounts.

Historical Background

5. Inflation accounting has been under discussion within the professional accounting bodies in the United Kingdom and Ireland for many years. Comments on the effects of changing prices on stock valuation and the proper treatment of additional amounts provided from profits for the replacement of fixed assets appeared in Recommendations N.9 and N.10, issued by the Institute of Chartered Accountants in England and Wales, as early as 1945. However, the first formal pronouncement by the Institute on the effect of changing price levels on accounts appeared in 1949 in Recommendation N.12. This discussed the problems arising for companies when prices are rising and increased amounts of capital are required to replace assets consumed in the course of business, and recommended that "any amount set aside to finance replacements (whether of fixed or current assets) at enhanced costs should not be treated as a provision which must be made before profit for the year can be ascertained but as a transfer to reserve". It also suggested that fixed assets should not, in general, be written up for balance sheet purposes on the basis of estimated replacement costs. The current purchasing power method was not mentioned in N.12.

6. In May, 1952, the Institute issued a further Recommendation, N.15, "Accounting in relation to Changes in the Purchasing Power of Money", which discussed the problem in greater detail and examined some of the methods of full-scale inflation accounting, including the "index method of adjusting accounts to reflect changes in the purchasing power of money" (as the CPP method was then called) pointing out their relative advantages and limitations. The statement concluded that none of the procedures which had been put forward — including the "index method" — was an acceptable alternative to the existing principles based on historical cost and re-emphasised the recommendation contained in N.12. However, it was also suggested that companies should consider experimenting with methods of measuring the effects of changes in the "purchasing power" of money on profits and on financial requirements. The Institute of Chartered Accountants of Scotland made a similar recommendation to its members in 1954. During 1952, the Institute of Cost and Works Accountants and the Association of Certified and Corporate Accountants both published books which advocated accounting for price level changes, mainly on a replacement cost basis.

7. Following the publication of N.15, the Council of the English Institute invited other professional bodies to join with it in further study of the

subject. Two meetings were held during the next 18 months but no agreement was reached on the method of inflation accounting which should be adopted and the discussions were closed without any further recommendations being added to the Institute's statement in N.15.

8. During the next 15 years the subject of inflation accounting appears to have fallen out of prominence and the accounting bodies made few public statements about it. This may in part have been due to the relatively small increase in prices during this time. However, further research into the subject was undertaken by the accounting bodies during these years and as rates of inflation began to increase after 1967, inflation accounting again began to attract attention.

9. In 1968, the Research Foundation of the Institute of Chartered Accountants in England and Wales published a paper entitled "Accounting for Stewardship in a Period of Inflation". This discussed the impact of inflation on companies and described in some detail the practical procedures required to adjust accounts for changes in the "purchasing power" of money.

10. The Accounting Standards Steering Committee (ASSC) began to consider the subject of inflation accounting soon after its formation in 1969. In 1971, the Accounting Standards Steering Committee authorised the publication of a paper entitled "Inflation and Accounts — Discussion Paper and Fact Sheet" which had previously formed the basis of a discussion on accounting for changes in the purchasing power of money at two plenary meetings of the Committee. The paper suggested that companies should continue to publish accounts on a historical cost basis but that in addition a supplementary statement should be presented showing the result of converting the conventional accounts into £s of current purchasing power (CPP) using a "general index of prices". The method of conversion proposed was the same as that put forward in the paper "Accounting for Stewardship in a Period of Inflation" published by the Research Foundation of the Institute of Chartered Accountants in England and Wales three years earlier.

11. In January, 1973, the Accounting Standards Steering Committee published Exposure Draft 8 (ED8), "Accounting for Changes in the Purchasing Power of Money", which was based substantially on the ideas put forward in the previous Discussion Paper. It was suggested that the requirement to produce supplementary CPP statements should apply initially only to quoted companies. The Exposure Draft proposed that the index to be used for converting the accounts should be the Consumer Price Index but after further discussion with the Central Statistics Office on the choice of the most appropriate index, the ASSC recommended in December, 1973

that the Retail Price Index should be used. Also in 1973 a two-volume book "Accounting for Inflation: A Working Guide to the Accounting Procedures" was published by the Trustees of Chartered Accountants' Trust for Education and Research of the Institute of Chartered Accountants in England and Wales. This publication contains a detailed description of the accounting procedures required to put the CPP method into practice.

12. Early in 1972, the Confederation of British Industry (CBI) set up a committee under the Chairmanship of Sir David Barran to examine the problems posed by the effect on financial statements of changes in the "value of money". The Committee maintained close contact with the ASSC and in January, 1973 it issued an interim report concluding that inflation accounting was desirable and that the ASSC's proposals should be supported although with some reservations. A final report was issued in September, 1973 which resolved some of the reservations expressed earlier and agreed that the ED8 proposals should be adopted by all quoted companies and by all corporations in the public sector.

13. On 25 July, 1973 the then British Secretary of State for Trade and Industry announced his intention to set up a Committee of Enquiry on the whole subject of inflation accounting. (This Committee was formally established in January, 1974 under the chairmanship of F.E.P. Sandilands). Following the Secretary of State's announcement the ASSC decided to proceed with the preparation of a provisional Statement of Standard Accounting Practice (PSSAP) based on ED8. This was published on 14 May, 1974 as PSSAP7.

14. The main features of PSSAP7 are described in the standard itself. These are as follows:

"(a) companies will continue to keep their records and present their basic annual accounts in historical pounds, i.e. in terms of the value of the pound at the time of each transaction or revaluation;

(b) in addition, all listed companies should present to their shareholders a supplementary statement in terms of the value of the pound at the end of the period to which the accounts relate;

(c) the conversion of figures in the basic accounts into the figures in the supplementary statement should be by means of a general index of the purchasing power of the pound, and

(d) the standard requires the directors to provide in a note to the supplementary statement an explanation of the basis on which it has been prepared and it is desirable that the directors should comment on the significance of the figures".

15. In September, 1975, the Committee of Enquiry published their report "Inflation Accounting: Report of the Inflation Accounting Committee". In the report the Committee acknowledged the valuable contribution to the subject of inflation accounting made by the issue of ED8 and PSSAP7 but considered that "the most fruitful line of development in inflation accounting" lay in the development of a system based on the principles of value accounting which shows the specific effect of inflation on individual companies. Accordingly, they recommended that a system known as Current Cost Accounting should be developed. The Committee did not consider in any great depth the question of whether or not Current Cost Accounting was suitable for taxation purposes. Instead, they recommended that given a rapid decline in the purchasing power of money "a further general review of the basis of taxation of profits and income" should be undertaken. Such a review they felt was outside their terms of reference. The use of current cost accounts as a basis for taxation is dealt with in Chapter 26 of our report.

Differences between CCA and CPP

16. The essential difference between the philosophies embodied in the CCA and CPP methods of inflation accounting is that CCA responds to changes in the price of goods used by a business, while CPP recognises changes in the value of money, or its purchasing power in general. CCA is concerned with protecting the substance of the business as an entity in itself before reaching profit, and allocating the increased cost of maintenance to the two classes of financial interests in the business, namely the providers of debt and equity capital. CPP, on the other hand, protects the general purchasing power of the invested capital, seeking to maintain the opportunity for alternative investment on the implied assumption that the existing investment could be withdrawn. It should also be noted that under CPP, fixed assets and stocks cannot be stated at more than their value to the business, that is, their CCA value.

Preparation of CPP Accounts

17. The preparation of CPP accounts starts with the historical cost accounts to which certain adjustments are made. Capital allowances for tax calculated on the basis set out in paragraph 26.65 would replace depreciation. The only other adjustments required to arrive at CPP profit are in respect of the cost of sales and purchasing power gains and losses on monetary liabilities and assets. These are illustrated by reference to the example in Table 19.1.

TABLE 19.1

Accounts for year ended 31 December, 1981

Profit and loss account	Historical Cost Basis	Current purchasing Power Basis
	£000s	£000s
Turnover	64,000	70,919
Trading Profit	4,200	3,536
Corporation tax	700	700
Profit attributable to shareholders	3,500	2,836
Proposed dividends	300	300
Retained profit of the year	3,200	2,536

Historical Cost Balance Sheet at 31 December, 1981

1980 £000's	1980 £000's		1981 £000's	1981 £000's
	11,502	Fixed assets		12,202
		Current assets:		
2,000		Cash	3,000	
6,000		Stock	8,000	
9,000		Trade debtors	10,500	
17,000			21,500	
		Current liabilities:		
5,000		Trade creditors	6,000	
1,000		H.P. creditors	700	
3,000		Overdraft	2,300	
750		Taxation	700	
250		Proposed dividend	300	
10,000			10,000	
	7,000	Net current assets		11,500
	18,502			23,702
	6,000	Share capital		7,000
	5,502	Reserves		9,702
	11,502	Shareholders' capital and reserves		16,702
	6,000	Convertible debentures		6,000
	1,000	Deferred tax		1,000
	18,502			23,702

18. The adjustments are calculated as follows:

(a) *CPP cost of sales adjustment*

				£000's
Opening stock	(HC) 6,000 ×	$\frac{123}{96}$	(a) = 7,687 Increase (b)	1,787
Closing stock	(HC) 8,000 ×	$\frac{123}{118}$	(a) = 8,339 Increase (c)	(339)
				1,348

(b) *Purchasing power gains and losses*

(i) *Short-term monetary position*	HC £000's	CPP £000's	CPP Gain/(Loss) £000's
Position at 1/1/81			
Current assets	11,000	13,667	(2,667)
Current liabilities	10,000	12,424	2,424
Net current assets	1,000	1,243	(243)
Net cash flows during year	2,500	2,770	(270)
Position at 31/12/81	3,500	4,013	(513)
(ii) *Long-term monetary position*			
Convertible debentures	7,000	7,000	
Purchasing power at 31/12/81 = 7,000 × 123 (a) / 99 (d)		8,697	1,697
		net adjustment	1,184
		Depreciation, say	(500)
		Total net adjustment	(664)

Relevant consumer price index figures

(a) index 31 December, 1981 =	123
(b) index mid November, 1980 — average date of purchase =	96
(c) index mid October, 1981 — average date of purchase =	118
(d) index 31 December, 1980 =	99
(e) (index 31 December, 1981 + index 31 December 1980) ÷ 2 =	111

The monetary position at the beginning of the year has been expressed in pounds of the purchasing power at the end of the year by applying the indices [a]d. It has been assumed that cash flows accrued evenly over the year and these have been adjusted by applying the index [a]e.

APPENDIX 20

DEPRECIATION OF ASSETS FOR TAX PURPOSES

1. Tax legislation has always drawn a distinction between capital and income. As a result, capital expenditure is not allowed as a deduction for the purposes of the taxation of income and profits. However, the fact that fixed assets may be consumed in the production of income is recognised by the provision of capital allowances which are deducted from income for tax purposes. The system of capital allowances, which has been subjected to frequent changes, is the product of two distinct motives. There is the political or economic goal of encouraging investment and the fiscal recognition that depreciation of capital assets has to be made good from revenue profits, justifying the setting off of the cost of the investment against profits for tax purposes.

Present Position

2. Capital allowances are granted for chargeable periods, that is, accounting periods in the case of companies liable to corporation tax, and years of assessment in the case of persons liable to income tax. This means that the amount of the allowances is computed by reference to events occurring in an accounting period (companies) or in a basis period for a year of assessment (other persons).

3. The capital allowances granted in Ireland are as follows:

(i) *Plant and Machinery*

There is an *annual allowance* for the wear and tear of plant and machinery in use for the purpose of a trade, profession, vocation or employment at the end of a basis or accounting period. In the first period of claim, the allowance is calculated by reference to the gross historical cost of the item, ignoring grants from any source. In subsequent periods, the allowance is calculated by reference to the cost as reduced by allowances for previous periods, i.e. the written-down value.

The taxpayer has the option of claiming up to 100 per cent of the cost of new (that is, unused and not second-hand) plant and machinery (free depreciation) for the first period in which it is in use. Should he claim less than 100 per cent in the first period, he may claim the balance in a subsequent

period, or periods, subject to the provision that the minimum claim for any period is to be the wear and tear allowance which could have been claimed if free depreciation has not been claimed. Annex I shows the various rates of annual allowances.

(ii) *Motor Vehicles*

Free depreciation does not apply to motor vehicles. The rate of annual allowance which is applied to such vehicles is 20 per cent of the historical cost on the reducing balance. The annual allowances on passenger motor cars purchased on or after 29 January, 1976 and costing more than £3,500 are computed as though the cars had cost £3,500. The relevant limit is £2,500 on cars purchased in the period between 16 May, 1973 and 28 January, 1976.

(iii) *Initial allowance*

An initial allowance may be granted in respect of capital expenditure incurred on new plant and machinery (other than motor vehicles) in an accounting or basis period for the purpose of a trade or profession. The allowance also applies to second hand ships. The rate of initial allowance is at present 100 per cent. Annex I contains the rates of initial allowance applicable. It is important to note that both initial allowance and free depreciation cannot be claimed on the same expenditure. In addition, the total of annual and initial allowances is limited to the historical cost of an item. However, initial allowance may be due in certain instances where free depreciation is not — for example, where expenditure has been incurred but the plant and machinery has not yet been brought into use.

(iv) *Balancing Allowances and Charges for Plant and Machinery*

Balancing allowances and charges may arise when one or more of the following events occurs in a period:

(a) An item of plant and machinery on which initial or annual allowance was granted is sold or otherwise disposed of.

(b) Such an item ceases permanently to be used for the purposes of the trade or profession.

(c) The trade or profession ceases.

Where the sale proceeds realised on an item are less than its written-down value a balancing allowance is granted of the difference. Where the sale proceeds exceed the written-down value a balancing charge is made of the difference. The balancing charge cannot exceed the aggregate of initial and annual allowances previously obtained on the item. For purposes of computing balancing allowances and charges, grants obtained on the purchase

of an item are treated, in effect, as capital allowances obtained and are deducted from the written-down value. The calculation of the balancing allowance or charge is made by reference to the resultant figure. In a case where the figure is negative, it is administrative practice to confine the balancing charge to the amount of the proceeds of the disposals of the asset. This may be illustrated as follows:

Cost of asset	100
Grant	35
Net cost	65
Capital allowances	100
Written down value	−35
Sales proceeds	40
Balancing charge	40 (not 75).

A taxpayer may elect to reduce the cost of the replacement of an item by any balancing charge arising on the disposal of the item. When the replacement is disposed of, any balancing allowance or charge arising will take account of the balancing charge previously withheld.

(v) *Industrial Buildings and Farm Buildings*

An industrial building writing-down allowance is granted to a person who at the end of a basis or accounting period holds the relevant interest[1] in an industrial building in use for the purpose of a trade carried on by him. An industrial building is defined as a building or structure in use

(a) for the purposes of a trade carried on in a mill, factory or similar premises, or

(b) for the purposes of a dock undertaking, or

(c) for the purposes of growing fruit, vegetable or market garden produce, or

(d) for the intensive production of cattle, sheep, pigs, poultry or eggs in the course of a trade other than farming, or

(e) as hotels, holiday camps or registered holiday cottages.

Where part of the building is an industrial building an allowance is granted granted on the whole building, provided that the industrial building accounts for at least 90 per cent of the whole structure.

An initial allowance (Industrial Buildings Allowance) may be granted in

[1] The "relevant interest" means the interest in the premises to which the person who incurred the capital expenditure was entitled when he incurred that expenditure. Where the relevant interest has changed hands since the qualifying expenditure was incurred the allowances may be claimed by the successor in title, whether he has succeeded by virtue of purchase, inheritance, expiration of a lease or otherwise.

respect of capital expenditure incurred by a person in an accounting or basis period on an industrial building to be used for the purposes of a trade carried on by him. Industrial buildings allowances are given on a straight-line basis, as opposed to allowances in respect of plant and machinery which are given on a reducing balance basis. In addition, industrial buildings allowances are given by reference to the net cost of the building, after taking account of any grants received, as opposed to allowances in respect of plant and machinery which are given on the gross cost. The rates of allowance now in force in respect of expenditure incurred are as follows:

	Initial Allowance	Annual Allowance	Maximum amount available first year
	%	%	%
Industrial buildings (other than those in categories (c), (d) and (e) above)	50	up to 100	100
Hotels etc.,	10	up to 100	100
Farm buildings	Nil	up to 30	30
Market garden buildings	20	up to 10	30
Buildings for the intensive production of livestock etc.	20	up to 10	30

(vi) *Balancing Allowances and Charges — Industrial Buildings*

In general these follow on the same lines as those for plant and machinery. In relation to expenditure incurred prior to 16 January, 1975, no balancing allowance or charge can arise as a result of any event occurring more than 50 years after the building was first used. The period is 25 years in relation to expenditure incurred on or after 16 January, 1975, but for hotels and buildings or structures in use for the purposes of market gardening or for the intensive production of cattle, sheep, or pigs the period is 10 years for all expenditure.

(vii) *Lessors*

In general lessors who derive income from the leasing of plant and machinery or industrial buildings are entitled to the same capital allowances as those who purchase and use such items in their own businesses. This does not apply to free depreciation on industrial buildings.

(viii) *Expenditure on Dredging*

There are reliefs on expenditure incurred on or after 30 September, 1956 on "the removal of anything forming part of or projecting from the bed of the sea or of any inland water". The expenditure must be for the purposes of a qualifying trade. The reliefs are an initial allowance of 10 per cent and an annual allowance of 2 per cent.

(ix) *Scientific Research — Capital Expenditure*

In the case of expenditure incurred since 6 April, 1965 the full amount of the expenditure is allowed for the period in which the expenditure is incurred.

(x) *Expenditure on Patent Rights*

Subject to certain restrictions, capital expenditure incurred by a trader on the acquisition of patent rights may be written off in equal annual instalments over a period of seventeen years (corresponding to the normal statutory life of an Irish patent), or over the remaining life of the patent if shorter.

(xi) *Expenditure on Farm Buildings*

The provisions in relation to capital allowances relating to farming are dealt with in Appendix 25.

Historical Background

4. A tax deduction for depreciation was not officially recognised in the United Kingdom until 1878, when wear and tear was first allowed, and then only on plant machinery. The Royal Commission on the Income Tax which reported in 1920 was opposed to the general principle of capital allowances for wasting assets but accepted wear and tear allowances for assets which had an estimated life of less than 35 years (roughly a generation), provided the assets were created by the "expenditure of capital". The general effect of the report was to approve the allowances for capital wastage on plant and machinery provided in 1878 but not to extend them.

5. A basic objective of Irish economic policy has been to set in motion and sustain a satisfactory rate of economic development. To do this incentives to stimulate investment in the industrial sector have been provided. Allowances for capital expenditure have been regarded as forming an important part of these incentives.

6. Up to 1946, the tax law in Ireland provided, by way of relief for capital expenditure, an annual deduction for expenditure on plant and machinery used in trading operations, supplemented by obsolescence and replacement allowances. The reducing balance method and used in calculating the allowances which varied from 5 per cent to 20 per cent of the written-down value for various types of plant and machinery, depending on the length of the useful life of the asset. The rates could be increased if there was abnormal working of the plant and machinery, such as double-shift working. For mills, factories, and similar premises the only depreciation allowance was a deduction equivalent to one-sixth of the annual value of the premises.

7. In 1946, provision was made for tax allowances for capital expenditure incurred, by a person carrying on a trade, on scientific research related to the trade. The allowance was 20 per cent of the expenditure in the year in which it was incurred and 20 per cent in each of the following four years. In 1965, it was provided that an allowance for the whole of the capital expenditure would be given in the year in which it was incurred and in 1968 the allowance was extended to capital sums spent by a trader on scientific research even if it was not related to his own trade.

8. The Committee of Inquiry into Taxation on Industry which reported in March, 1956 made a number of recommendations with regard to capital allowances, the principal of which were as follows:

Industrial Buildings

(i) an initial allowance of 10 per cent of new capital expenditure on industrial buildings;

(ii) annual wear and tear allowances on the remainder of that expenditure on the reducing balance basis, and

(iii) a notional allowance on capital expenditure already made on industrial buildings.

Plant and Machinery, excluding vehicles

(i) an initial allowance of 20 per cent of new capital expenditure, and

(ii) a 25 per cent increase in all the basic wear and tear rates.

These recommendations followed closely the pattern of capital allowances being granted at the time in the United Kingdom.

9. Following this report, the Finance (Miscellaneous Provisions) Act, 1956 provided for the granting of an initial allowance of 20 per cent of capital expenditure incurred after 5 April, 1956 on the provision of new plant and machinery (excluding road vehicles) or of ships whether new or second-hand. The initial allowance was subsequently increased in 1962 to 40 per cent, in 1967 to 50 per cent, in 1968 to 60 per cent and in 1972 to 100 per cent.

10. In 1956, an initial allowance of 10 per cent of capital expenditure incurred after 29 September, 1956 on the construction of certain industrial buildings or structures (including hotels) was granted. In 1959, an annual allowance of 2 per cent was given in respect of the same expenditure. For capital expenditure on hotels, the annual allowance was increased to 10 per cent in 1960. In 1962, the initial allowance for industrial buildings, other than hotels, was increased to 20 per cent.

11. In 1957, a shipping investment allowance of 40 per cent of capital expenditure on new ships was introduced. Until 1971 this allowance was in substitution for, rather than in addition to, the initial allowance mentioned in paragraph 9. It was suspended in 1973 and abolished in 1978. The initial allowance could be claimed in respect of capital expenditure on new or second-hand ships.

12. An important development was the introduction in 1967 of free depreciation in respect of new machinery or plant (other than road vehicles) provided for use in the designated areas, mostly located in the West of Ireland. The option to elect for free depreciation was extended to the rest of the country in 1971 for similar new machinery or plant brought into use on or after 1 April, 1971. An investment allowance of 20 per cent was introduced for similar expenditure in the designated areas. This could be claimed in addition to the initial allowance or free depreciation but was repealed in respect of expenditure incurred after 31 December, 1980. The increase in the initial allowance to 100 per cent was designed to complement the free depreciation provisions by enabling the equivalent of free depreciation to be claimed in cases where capital expenditure was incurred but the asset could not be brought into use until later.

13. In 1975, the initial and annual allowances in respect of capital expenditure incurred on or after 16 January, 1975 on industrial buildings were increased to 50 per cent and 4 per cent respectively. Free depreciation was extended to industrial buildings (other than those used in market gardening or intensive production of livestock etc.,) and hotels for expenditure incurred after 2 February, 1978.

14. Accelerated depreciation allowances have been introduced to provide incentives for investment and have been regarded in that light. They have never been justified on the grounds that they provided the equivalent of depreciation on a replacement cost basis. According to the White Paper on Company Taxation in Ireland published in November, 1972, "these increases and extensions were made from time to time with a view to encouraging further investment in the assets essential for industrial development".[2] When making free depreciation permanent in 1978, the Minister for Finance stated in his budget speech that "the Government have decided that the need for industrial growth would be better served by allowing free depreciation for plant and machinery as a normal and continuing feature of our capital allowances arrangements for the whole country".

[2] paragraph 57.

APPENDIX 21

DISPOSAL OF FIXED ASSETS — EXAMPLES OF CALCULATIONS OF CHARGES/ALLOWANCES

1. In this appendix we give an example of the calculation of balancing charges and allowances and capital gains under the scheme outlined in paragraphs 26.65 to 26.69.

Assumptions

Plant & machinery	Cost £1,000 on 6 April 1974
Wear & tear rate	12½%
Sale proceeds	(a) £4,000 on 6 April 1981
	(b) £ 200 on 6 April 1981

Accounting period year ended 5 April

Balancing Charge/(Allowance)		(a) £	(b) £
Sale proceeds		4,000	200
Limited to Original indexed cost or price realised £1,000 × 2.812		2,812	200
Original cost	1,000		
Allowances given	607		
Historical cost written down value	393		
Written down value indexed from purchase to sale		1,105	1,105
Balancing charges/(allowance)		£1,707	£(905)

Capital Gain	£	
Sale proceeds	4,000	—
Indexed cost	2,812	—
Capital gain	£1,188	—

APPENDIX 22

LOSSES CARRIED FORWARD

Existing legislation provides that losses and capital allowances are carried forward and backwards at their historical amounts. If the period of carry-forward is lengthy, the value of losses is reduced by inflation. This is shown in the following example.

Assume:

1. Accounting income = taxable income; tax rate 45 per cent
2. Inflation: 10 per cent per annum compound.
3. Index then is:

Year 1	100
Year 2	110
Year 3	121
Year 4	133

Step 1 — No adjustment of Losses Forward

	Year 1 £	Year 2 £	Year 3 £	Year 4 £	Total £
Accounts results:					
Profit/(loss)	(100)	20	120	200	240
Tax Computation:					
Profit/(loss) for year	(100)	20	120	200	
Less losses forward	—	(20)	(80)		
Taxable profit	Nil	Nil	40	200	240
Tax charge (45%)	Nil	Nil	18	90	108
Restate profit and tax charge for each year in terms of year 1 purchasing power:					
Profit/(loss)	(100)	18	99	150	167
Tax charge	—	—	15	68	83

(Opening losses available for carry forward		100	73
(Revalued	$(100 \times \frac{100}{110})$	91 $(73 \times \frac{100}{121})$	66
(Less: used		18	66
(Closing losses for carry-forward		73	—

Effective rate of tax in constant purchasing power terms (83/167) = 50%
Effective rate of 50% exceeds tax rate of 45%.

Step 2 — Assume losses are indexed

	Year 1 £	Year 2 £	Year 3 £	Year 4 £	Total £
Tax computation:					
Profit (loss) for year	(100)	20	120	200	240
Less losses forward	—	(20)	(99)	—	
[illegible]	[illegible]	—	[illegible]	[illegible]	
Tax charge [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

(Opening losses available for carry forward	100	90
(Revalued	[illegible]	[illegible]
(Less used	20	99
(Closing losses for carry-forward	90	—

Restate profit and tax charge in terms of year 1 purchasing power:					
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Tax charge	—	—	[illegible]	68	[illegible]

Effective rate of tax in CPP terms [illegible] 75/167 = 45%

Conclusion:
When losses forward are indexed the "true" rate of tax equals the standard rate of 45%.
When losses forward are not indexed the "true" rate of tax (50%) exceeds the standard rate of 45%.

APPENDIX 23

THE TAX TREATMENT OF INCORPORATED AND UNINCORPORATED ENTITIES

1. In this appendix we show that the existing tax system is not neutral between incorporated and unincorporated entities and that there is scope for tax avoidance through the formation of a company. The analysis applies only to companies liable at the normal rate of corporation tax. We also indicate how the tax system discriminates between income taken out of companies by way of directors' remuneration and by way of dividend.

Incorporated and Unincorporated Entities

2. In order to minimise the taxation of profits arising to a close company and its shareholders/directors it is necessary to pay out as directors' remuneration such sums as will bring the directors' personal tax rates up to the rate of corporation tax but no further. Directors' remuneration is allowable as a deduction in computing profits for purposes of corporation tax. The use of directors' remuneration is particularly flexible since it need not be paid;[1] it needs merely to be credited to a loan or current account.

3. In the case of a married man, with no other allowances, the marginal rate of personal income tax exceeds 45 per cent (the normal rate of corporation tax) on profits exceeding £17,230 (at 1981/82 rates of tax). The formation of a company at income levels in excess of this figure could lead to a tax saving and would not be unfavourable at lower levels since all the profits could be paid out as remuneration so that the tax payable would be equivalent to that payable by a sole trader in similar circumstances (leaving out of account such considerations as the basis of assessment and arrangements for payment of tax). The magnitude of the possible advantage in terms of reduced tax payable to be obtained from forming a company may be ascertained from Table 23.1.

[1]PAYE may still be due even if the remuneration is not paid. See section 17 of Finance Act, 1976.

TABLE 23.1

Comparison of Tax Payable by Incorporated and Unincorporated Entities

Profits	Income tax 1981/82 payable by a self-employed married man	Corporation Tax	Personal income* tax	Total tax	Tax Saving
£	£	£	£	£	£
20,000	6,973.50	969.50	5,450	6,419.50	554.00
25,000	9,912.00	2,719.50	5,450	8,169.50	1,742.50
30,000	12,912.00	4,469.50	5,450	9,919.50	2,992.50
35,000	15,912.00	6,219.50	5,450	11,669.50	4,242.50
50,000	24,912.00	14,189.00	5,450	19,639.00	5,273.50

*If £17,230 is distributed as directors' remuneration

4. This, however, does not give a complete picture, for a company is a separate legal entity and profits retained in a company are not disposable income for the proprietors. If it is desired to put those profits in the hands of shareholders, there are further costs involved. The options are either to pay dividends or to liquidate the company. The consequences of the first course of action may be seen from the following example, using the top £100 of profit and comparing it with the sole trader at the top personal rate of 60 per cent. The sole trader will simply pay £60 in tax and then can spend the remaining £40 as he wishes. The tax payable through the company would be as follows:

			Total tax payable
	£		£
Profit	100		
Less Corporation Tax (reduced rate)	35		35.00
Dividends	65		
Tax credit 30/70ths of dividend	27.86		
Personal income tax	92.86 at 60 per cent =	55.71	
Less tax credit		27.86	27.85
			62.85

Therefore, in the case of small companies (those with profits under £25,000) the distribution of profits through the company may increase the effective marginal rate of tax to almost 63 per cent. In the case of a company liable to corporation tax at a rate of 45 per cent the effective maximum rate of tax on profits distributed to a shareholder liable at a marginal rate of 60 per cent would be 68.6 per cent. If the ultimate objective is to get disposable income into the hands of individuals this avenue is relatively unattractive.

Liquidations

5. If the trade is carried on for some years and the company is liquidated, the retained profits will effectively issue from the company as capital gains

on the disposal of the shares and would, therefore, under the proposals in the Finance Bill, 1982 be taxed at a rate of 40 per cent on the real increase in the value of the shares. This would give a maximum rate of tax on the profits of small companies as follows:

	£	Total tax payable £
Gains in year tax	100 35	25
	65 at 40 per cent	26
		61

6. The above analysis shows that there is little scope for tax avoidance by forming a company and taking the profits out in the form of capital gains by liquidating the company after a period.

Salaries and Dividends Paid by Companies

7. The inequity of a system which does not provide for a full tax credit on dividends can be seen from the following example. A married man with personal allowances of £4,000 owns a company with trading profits of £40,000. He can choose to extract this profit from the company by way of either salary or dividends. The position at present is as follows:

	By Salary £	Half Salary Half Dividend £	By Dividend £
Company			
Trading Profit	40,000	40,000	40,000
Salary	40,000	20,000	NIL
Taxable Profit	NIL	20,000	40,000
Tax	NIL	7,000	18,000
Profit after tax	NIL	13,000	22,000
Dividend	NIL	13,000	22,000
Individual			
Income: Salary	40,000	20,000	NIL
Dividend	NIL	13,000	22,000
Tax Credit	NIL	5,571	9,429
Income for tax purposes	40,000	38,571	31,429
Total tax payable	19,050	18,193	13,907
Less tax Credit	NIL	5,571	9,429
Tax payable	19,050	12,622	4,478
Total tax			
Company	NIL	7,000	18,000
Individual	19,050	12,622	4,478
	19,050	19,622	22,478
Net Income of Individual	20,950	20,378	17,522

8. The overall tax charge and the taxpayer's net income depends on the way the profit is taken out of the company. In the examples taken all the company's profits are distributed to the proprietor. It is clearly inequitable and inefficient that different tax liabilities arise as a result of the method chosen to distribute these profits.

APPENDIX 24

TAX-RELATED LENDING

1. In this appendix the main forms of tax-related lending are described. These are forms of finance used by banks to obtain benefits from certain provisions of tax law. These benefits are in large measure passed on to customers in lower charges. The types of finance in question are (i) leasing, (ii) preference-share financing, (iii) Section 84 type loans, (iv) house purchase loans and (v) loans to certain farmers.

Leasing

2. Under a leasing transaction, a bank buys the asset and leases it back to the user company. The principal and interest are paid by "rentals" at regular intervals — usually rentals are paid quarterly over a five-year period. This is called the primary leasing period. The bank receives any grants which have been negotiated and can offset the capital allowances on the gross value of the leased asset against its taxable profits. The company gets the benefit of low cost rentals where the bank's tax saving is fully or partially passed on. At the end of the primary leasing period, a secondary lease is arranged during which the asset is available for use by the company at nominal cost. This period normally covers the remaining useful life of the asset.

3. The Industrial Development Authority (IDA) imposes certain controls on leasing transactions. It limits the amount of fixed assets which a promoter may lease and on which the IDA will pay a grant. Companies can in general only lease 35 per cent of their machinery and equipment needs. In each case the IDA enters into a legal contract with the bank involved, committing the bank to pass on the benefit of the capital grant it receives in the form of low lease rentals which the promoter pays on the leased assets. Banks remain contingently liable to repay the IDA grant during the primary leasing period. In approving projects, account is also taken of the estimated cost to the State from such leasing.

Preference-share Financing

4. In a preference share transaction the bank ranks as a shareholder and as such only makes such facilities available to prime customers. Preference

shares involve extra costs for the borrower such as stamp duty. They can only be repaid out of profits or new issues of capital and they have adverse implications for a company's capital structure. Preference share finance is usually provided for between three and five years. Due to legal and other administrative charges, the minimum amount is about £0.25 million. The principal is repaid by redeeming the shares in agreed tranches or by one final redemption.

5. Preference share finance is granted by banks to companies which qualify for export sales relief on their profits. Dividends on the preference shares paid out of tax-free profits are tax-free in the hands of the recipient. Thus dividends received by a bank under this form of lending are free of tax. Preference share financing grew until 1977 when it was largely replaced by Section 84 loans.

Section 84 Loans

6. Section 84 of the Corporation Tax Act, 1976 was introduced as an anti-avoidance measure. Section 84 lending is based on the definition of "distribution" in the Act. The result is that certain interest paid (where the return of the lender is to "any extent dependent on the results of the company business") is classed as a distribution. As such, it is tax-free in the hands of the recipient company though it is not allowable as a deduction for tax to the paying company. Loans arranged so that they come within the scope of Section 84 are of benefit to companies who are not liable for corporation tax.

7. It is likely that the importance of Section 84 loans will decline in the future. About 80 per cent of IDA clients will not be able to use the facility because they qualify for the 10 per cent rate of tax applicable to manufacturing companies. The tax credit on distributions by manufacturing companies will first be treated as being paid out of profits which attracted tax at the rate of 10 per cent and as such will carry a reduced tax credit thereby reducing the attractiveness of the mechanism. However, such loans would still be attractive to companies which had commercial profits but had losses for tax purposes or those which qualified for exports sales relief or were liable at a nominal rate of 45 per cent and paid little tax due to the operation of capital allowances.

House Purchase Loans

8. Section 28 of the Finance Act, 1976 provided a special concession to approved banks on their housing loan operations. Under the scheme, a bank's income from house purchase mortgages is charged to tax at a rate of 30 per cent (the rate provided for under section 79 of the Corporation Tax Act, 1976) while its costs are relieved from tax at the standard rate of

45 per cent.[1] The effect of the tax reduction is to enable the banks to receive a commercial rate of return — the A category loan account rate — while at the same time charging a mortgage rate which is significantly lower than it otherwise would be and which approximates to that charged by building societies. The current rate of interest charged by banks on house purchase loans is 17.25 per cent (as compared with 16.25 per cent for building societies) which combined with the tax concession gives them a gross equivalent interest charge of 22 per cent. which is the market rate at the time of writing.

Loans to Certain Farmers

9. In March, 1982, a scheme was announced by the Minister for Agriculture to assist some selected farmers in severe financial difficulty. The scheme entails the charging of a lower rate of interest on certain loans to farmers. Under the scheme, the Exchequer reimburses a bank in respect of 50 per cent of the loss after tax saved attributable to the reduction of the rate of interest. In the case of a bank which is resident for tax purposes in this country, the direct Exchequer contribution is made by way of a credit against Irish corporation tax which would otherwise be payable. This applies to Allied Irish Banks Limited and the Bank of Ireland.

10. A direct subvention is made in the case of the Agricultural Credit Corporation Ltd., since it is considered most unlikely that the Corporation would have significant taxable profits during the period of the scheme against which to set a credit. There are similar arrangements for banks which operate here but are not resident for tax purposes in Ireland.

---

[1] An increase in the standard rate of corporation tax from 45 per cent to 50 per cent was announced in the budget on 25 March, 1982. When combined with a consequential recommended change in the special rate of 30 per cent to 35 per cent, the banks' house purchase mortgage rate should become 17 per cent.

APPENDIX 25

TAXATION OF FARMING PROFITS: HISTORICAL BACKGROUND

1. Until 1969, income from land for income tax purposes was measured on a notional basis. Land was regarded as yielding income from ownership assessed under Schedule A and income from occupation assessed under Schedule B. Where the owner was also the occupier, his income for income tax purposes was the total of the amounts assessed under both Schedules A and B. Where the owner was not the occupier, the owner's income from the land was measured by the amount of the Schedule A assessment and the occupier's income was measured by the amount of the Schedule B assessment. In general, the notional income from land under both Schedules A and B amounted to about one and a half times the land valuation.[1]

2. When income tax was reintroduced in Britain in 1842, Schedule A assessments were based on letting values. As regards Schedule B, up to 1914/15 the basis of assessment, both in Ireland and in Britain, was normally one-third of the valuation. With the increase in profits from land after the start of World War I, the basis of the Schedule B assessment was increased in 1915 to the full "annual value". In 1918, the basis was further increased to twice the "annual value", but in 1922 it was reduced to the annual value as in 1915.

3. In 1920, the Royal Commission on the Income Tax[2] recommended that income from land should no longer be based on notional measurements for income tax purposes, but on actual profits obtained, as in the case of trades and professions. No action was taken on that recommendation. In 1941, however, the notional basis of Schedule B assessment in the United Kingdom was changed to that of actual profits in respect of holdings of land exceeding £300 valuation. In 1942, the £300 limit was reduced to £100. As from 1949/50, the £100 limit was removed, so that since then income taxation on the profits from occupation for all agricultural land in the United Kingdom has been based on actual profits. Since 1929, agricultural land and buildings in the United Kingdom have been, in general, exempt from rates.

---

[1] *Commission on Income Taxation Fourth Report*, Prl. 5731 paragraph 3.
[2] *Report of Royal Commission on the Income Tax*, 1920, Cmd. 615, paragraph 452.

4. The Commission on Income Taxation devoted its Fourth Report,[3] which was published in September, 1960, to the question of the taxation of farming profits. The main recommendation[4] of this report was that each person whose land had a valuation of £100 or more should be subject to income tax on his actual profits and that the figure of £100 should be gradually reduced so that ultimately all who derived a taxable profit from the land would be charged tax on the basis of actual profits. The Government rejected this recommendation.

5. In 1969, income tax assessments under Schedules A and B were abolished. Thus, between 1969 and 1974 there was no tax on farming profits. However, a taxpayer occupying land for husbandry still had the right to claim a farming loss in those years in which he made a loss and to set this against any other income. Any corresponding profit was not charged to tax.

Taxation of Farming Profits: Developments since 1974

6. The Finance Act, 1974, imposed a charge to tax on certain farming profits. It also provided for a restriction of personal reliefs in certain other cases and introduced restrictions in relation to relief for certain farm losses. Broadly speaking, all farmers with a valuation of £100 or more were charged to tax. This threshold was later reduced to £75 for 1977/78, to £60 for 1978/79, to £50 for 1979/80 and to £40 for 1980/81. The present position in relation to the taxation of farming profits is as follows:

(i) Farmers with an annual land valuation of £40 or more are now chargeable to tax on their farming profits;

(ii) Since 1974, farming companies have been charged to tax irrespective of their land valuation. Previously, companies were liable to corporation profits tax on actual farming profits but not to income tax;

(iii) Where an individual or his spouse carries on another trade or profession, or is the director of a trading company and owns or controls more than 25 per cent of the ordinary share capital of the company, then his or her profit from farming is also chargeable to tax in full, irrespective of valuation;

(iv) In addition, an individual who has other income from a non-farming source, and who is not otherwise chargeable to tax on his farming profits and who occupies farm land the rateable valuation of which exceeds £20, has his personal allowances restricted by the lowest of the following amounts:

(a) one-half of the total of personal allowances, or

(b) eighty times the amount by which the rateable valuation of the land exceeds £20, or

(c) the actual amount of the farming profits.

The main category of persons affected by this provision are farmers with a valuation of between £20 and £40 who have other employment. Where a farmer's wife has the non-farming income, she is assessed as a single person;

(v) There is also provision for marginal relief for farmers with no trading income other than from farming and who occupy land with a valuation of between £40 and £49, whereby the amount of tax payable is a graduated proportion of the amount assessed;

(vi) Relief from farm losses against other income may be claimed only where the farming is carried on on a commercial basis and with a view to the realisation of profits and if a profit had arisen it would have been chargeable to tax. The relief is normally available in the event of losses in consecutive years for three such years but, in special cases relief, may be allowed for a fourth consecutive year. If there is no other income or if relief is denied because of the three/four year rule, the losses may be carried forward and set against farming profits;

(vii) Up to 1980, full-time farmers had the option of being assessed on a notional income which rose from 40 times the land valuation in 1974/75 to 125 times the valuation in 1979/80. As from 1980/81, all farmers liable for income tax are assessed by reference to their actual profits as shown in accounts ending in the preceding year of assessment. In 1980, farmers in the valuation range £40 to £50, who entered the tax system for the first time, had the option of presenting current year accounts. These farmers also had the option of using a simplified form of accounts. The simplified form of accounts was made available to other small-enterprise farmers;

(viii) Full-time farmers can credit 50 per cent rates paid in the preceding year against their income tax for 1982/83. Rates claimed as a credit cannot be deducted as an expense in computing farm profits. The maximum credit claimable is the lesser of the rates or the tax appropriate to the farming profits;

(ix) For 1980/81, full-time farmers were allowed two payment dates (1 October and 1 January) rather than the single payment date of 1 October which applies to other Schedule D taxpayers. This concession also applied in 1981/82 and 1982/83;

[3] Prl. 5731 paragraph 143.
[4] Paragraph 77.

(x) Prior to 1980/81, farmers qualified for stock relief in the same manner as any other qualifying person, that is, relief was given in respect of 75 per cent of the excess of stock increases over 20 per cent of net profit. In 1980/81, this was improved for farmers so that in their case, full relief was given in respect of increases in stock values. For 1982/83, the stock relief provisions for farming were improved so that farmers are entitled to claim 110 per cent relief in respect of increases in the value of livestock. In addition, since 1980/81, a decrease in stock brought about by the compulsory disposal of stock under any statute relating to the eradication or control of diseases in livestock does not bring about a stock relief clawback. In this respect, it is provided that the farmer may elect that the value of the closing stock in the year in which the disposal takes place is to be increased by the value of the stock disposed of. Notice of election must be given to the inspector of taxes within one year of the end of the year to which the accounts are made up;

(ix) The farming profits of a charity are exempted from tax where the profits are applied solely for the purposes of the charity, and

(xii) Farmers liable to income tax on their farming profits are entitled to claim capital allowances on plant and machinery and farm buildings. The main allowances are as follows:

Plant and Machinery

All farm machinery owned prior to 1974/75 qualifies for wear and tear at rates of 10 per cent, 12½% per cent, or 25 per cent. This allowance is deemed to have been granted for every previous year of ownership, so that the resultant written-down value at the date the farmer came into the tax net can be regarded as the cost price of the machinery. New machinery qualifies for free depreciation which means that a farmer can choose any rate up to 100 per cent. He cannot claim less than the minimum allowances of 10 per cent, 12½ per cent or 25 per cent depending on the life expectancy of the machine. Free depreciation on certain farm machinery and plant is restricted so that the total for a year of assessment of the capital allowances in respect of farming profits cannot, by reason of the free depreciation, exceed 30 per cent of the farming profit. This restriction only applies to farmers and is confined to machinery and plant in use for the purposes of farming but not including fixed machinery and fixed plant designed to be used exclusively in a farm building.

Farm Buildings

Expenditure on farm buildings may be written off over a period of

between four and ten years with up to 30 per cent being claimed in any one year. A minimum of 10 per cent must be claimed each year. This relates only to expenditure incurred after 6 April, 1980. Expenditure incurred after 6 April, 1974 qualifies for an initial allowance of 20 per cent and an annual allowance in the first year and in each year thereafter of 10 per cent, i.e., an eight year writing-off period. These allowances can be claimed on the construction of farm buildings, fences and sewerage, water and electricity installation and reclamation of former agricultural land. Expenditure incurred on or after 6 April, 1977 on the construction of fences, roadways, holding yards and drains or on land reclamation can be written off in one year. With effect from 6 April, 1982 capital allowances in respect of the cost of construction of farm dwellings are to be discontinued.

Income Averaging

7. A scheme of income averaging for full-time farmers has been provided from 1981/82. Broadly speaking, this provides that farmers may average profits over a three year period. The general question of averaging is considered in Chapter 19.

Resource Tax

8. A new resource tax on agricultural land was introduced in 1980/81 to apply to holdings with a rateable valuation of £70 and over. Charities were exempted from the tax which was charged at the rate of £3.50 for every pound of rateable valuation. There was a scheme of marginal relief for farmers with valuations between £70 and £79. Where land was let at a commercial rent, the charge to resource tax fell on the occupier. Farm land occupied in partnership was included only to the extent of the profit sharing ratio. The tax was not allowed as a deduction or credit for income tax purposes. Resource tax was abolished as from 6 April, 1981. Any resource tax paid will be refunded.

Rates on Land

9. Rates on land must be taken into account in any consideration of the taxation of farming profits. There is widespread derating of agricultural land through the agricultural grant, which is paid to local authorities by the Exchequer to enable them to give abatements of rates, without loss to themselves, to occupiers of agricultural land in their rating areas. It was first introduced in 1898 but the basis and distribution of the grant has been altered by a succession of temporary Acts. At present, the following scheme of allowances is in operation:

(i) A primary allowance of 100 per cent of the general rate in the pound is given for land holdings with a valuation not exceeding £20;

(ii) Holdings with a valuation of over £20, but not exceeding £33, for 100 per cent primary allowance. In these cases, the occupier is liable for rates only on the portion of valuation exceeding £20;

(iii) Holdings with a valuation of £33 or over but less than £40 qualify for primary allowance of 80 per cent of the general rate in the pound on the first £20 valuation and an allowance of 30 per cent on the balance, and

(iv) Holdings with a valuation of £40 and over get no relief. In 1980, as part of a package of measures designed to deal with declining farm income, the Government waived the second instalment of rates payable by farmers in the £40-£60 valuation range. In 1981, there was full relief from rates for farmers with a valuation under £50 and 50 per cent relief for farmers with valuations between £50 and £70.

APPENDIX 26

AGRICULTURE IN THE IRISH ECONOMY

1. Agriculture makes a substantial contribution to the development of the economy through

(i) direct employment of about 18 per cent (220,000) of the total at work;

(ii) providing employment of an estimated 26,000 people in related agri-business;

(iii) provision of raw materials for a substantial proportion of processing and manufacturing industries;

(iv) a balance of payments contribution (of almost £1,570m in 1981) which has a low import content, and

(v) employment and output generated in other sectors which service agriculture.

2. Over recent years, agricultural exports, in conjunction with a growing industrial base, have been responsible for much of the growth of the Irish economy. Agricultural exports have had a dual effect on the economy. Firstly, because of their low import content the multiplier effect on income has been higher than for most other industries. Secondly, they earn foreign exchange which provides the means to purchase imports of raw material and oil for further production in the economy as a whole.

3. Agriculture's relative contribution to the economy has, however, been declining over time. Between 1960 and 1980, its share of total employment has dropped from 36 per cent to 18 per cent and its share of gross national product fell from 24 per cent to 12 per cent. This is due mainly to the dramatic increase in the contribution made by the industrial sector rather than as a result of any absolute decline in the agricultural sector. Table 26.1 shows the relative contributions of agriculture and industry to G.N.P. over the period 1971-1980.

Agricultural Production

4. Although the climate in Ireland favours the growth of a wide range of crops — grass, cereals, roots, vegetables and fruits — most farmland is

TABLE 26.1

Agricultural and Industrial Product as a Percentage of Gross National Product at Factor Cost 1971-1980

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
	%	%	%	%	%	%	%	%	%	%
Agricultural Product	16.0	18.0	18.8	16.2	17.8	17.1	18.9	18.1	14.6	12.4
Industrial Product	36.2	36.1	37.1	39.1	36.3	37.6	36.0	36.4	37.8	37.9

Source: Economic Review and Outlook, Summer 1981.

under grass (approx 61 per cent in 1975). The minor role of arable farming is mainly due to the fact that climatic and other factors as well as market outlets tend to favour grassland. The relative dominance of grass *vis-a-vis* other crops is reflected in the position of livestock and livestock products in agricultural output. For the year 1980, livestock and livestock products accounted for about 85 per cent of gross agricultural output and crops and turf about 15 per cent. In the same year, livestock and livestock products accounted for 92 per cent of agricultural exports. Cattle production is the single major agricultural activity and of itself accounted for 37 per cent of gross agricultural output in the period 1974-1979. During this period, livestock production as a whole, however, declined from 54 per cent to around 50 per cent of gross agricultural output, the main decline being in the contribution of other livestock production (pigs, sheep, etc.,) from 17 per cent to 15 per cent. Over these years, milk production increased from 27 per cent to 32 per cent of total farm output.

Employment

5. The total numbers engaged in agriculture fell from 276,000 in 1970 to 220,000 in 1980. The rate of fall was declining from 1970 to the middle of the decade and since then has been around 3,000 a year. As a result, most farms are now family-based. The decline in the importance of agriculture as a source of direct employment is shown in Table 26.2.

6. The level of employment in agriculture in the future will be influenced by (a) the level of alternative job opportunities and its "pull effect" out of agriculture, (b) individual farmer's perception of how farm incomes will proceed in the near future and (c) the fact that such a large proportion of the change is of an involuntary nature (i.e. brought about by death or by voluntary retirement due to ill-health etc.) and a rate of inflow that is already very small.

[1]Pasture and rough grazing in use as a percentage of total utilised agricultural area. Statistical Abstract of Ireland 1978.

TABLE 26.2

Workforce in Agricultural, Industrial and Service Sectors as a Percentage of the Total Labour Force — at Mid-April, 1975-1980.

Year	Agriculture*	Industry	Services	Unemployed**	Total
	%	%	%	%	%
1975	20.8	29.4	43.4	6.4	100
1976	20.1	29.2	43.9	7.8	100
1977	19.4	28.7	44.3	7.6	100
1978	18.9	29.3	44.7	7.1	100
1979	18.3	29.9	45.7	6.1	100
1980	17.8	30.1	46.1	6.0	100

*Includes forestry and fishing

**The estimates given for those out of work do not include persons who are not yet at work having left full-time education. The 1979 Labour Force Survey showed that 14,000 such persons were seeking regular work for the first time in June 1979

Productivity

7. Over the seventies, gross agricultural output increased by 34.5 per cent (3.0 per cent per annum) and after allowing for the sharp increase in inputs, net agricultural output increased by 26.8 per cent (2.4 per annum). Despite the fact that output during the seventies did show an increase, concern has been expressed at the relatively low productivity per acre of Irish farms. Reasons such as poor farming methods, lack of land development, decline in investment in breeding stock may have prompted the Farm Management Survey of 1978 to comment "It would be fair to say that output per acre or per farm is generally far lower than could be achieved technically or that is economically justified".

Age-structure

8. From the point of view of achieving a substantial increase in output, the labour force in agriculture has too high a proportion of old people, many unmarried — and too few in the younger age groups. Attachment to the ownership of land is strong and farmers are reluctant to hand over even the management of farms to younger people. Table 26.3 gives a breakdown of the farmers by age and acreage.

Farm Size

9. One feature of Irish farming is the proliferation of small holdings, many of which are concentrated in the north-west of the country. In 1975, 17 per cent of farm holdings were under 15 acres, 48 per cent were between 15 and 50 acres, 23 per cent were between 50 and 100 acres and the balance were over 100 acres. The average size of holding was slightly less than 50 acres.[2]

[2]These figures are calculated after excluding all holdings under 5 acres.

TABLE 26.3

Analysis of Farmers by Age and Acreage

Acreage/Age	Under 55 years	55-65 years	Over 65 years	Total
Under 30 acres	25,350	18,048	19,887	63,285 (34.8%)
30-50	23,734	12,281	11,205	47,220 (26.0%)
Over 50	39,004	17,035	13,881	69,920 (38.5%)
Not Stated	639	271	292	1,202 (0.7%)
	88,727 (48.9%)	47,635 (26.2%)	45,265 (24.9%)	181,627 (100.0)

Source: 1971 Census of Population

Table 26.3 shows that one-quarter of all farmers are over 65 years. Approximately a further one-quarter are under 65 and farming less than 30 acres. Only about 22 per cent of farmers are under 55 years of age and farming over 50 acres. A further 13 per cent are under 55 and farming between 30 and 50 acres, while the remaining 15 per cent are between 55 and 65 and farming over 30 acres. Thus, a high percentage of land is in the hands of relatively older farmers who on average tend not to use it to best advantage.

Investment

10. Investment in agriculture rose from about £100m in 1973 to reach £342m in 1979 but declined to £267m in 1980. The increase was particularly noticeable in the case of farm buildings, although farm machinery remained the largest single category of investment throughout the decade. Table 26.4 gives a breakdown of capital investment and shows that buildings and

TABLE 26.4

Annual Capital Investment in Agriculture by Category 1973-1980

	Breeding Stock		Buildings		Land Improvement		Vehicles		Machinery		Other		Total
Year	£m	% of Total	£m	% of Total	£m	% of Total	£m	% of Total	£m	% of Total	£m	% of Total	£m
1973	+28.7	+28.3	16.7	16.5	6.2	6.1	14.7	14.5	25.4	25.0	9.7	9.6	101.4
1974	−13.1	−20.9	13.2	21.2	7.5	12.0	15.1	24.1	28.2	45.0	11.7	18.6	62.7
1975	−23.5	−30.4	25.8	33.4	8.2	10.6	16.4	21.3	37.4	48.4	12.9	16.7	77.2
1976	+ 5.7	+ 3.3	48.3	28.1	13.3	7.7	26.3	15.3	57.2	33.3	21.1	12.3	172.0
1977	− 1.9	− 0.8	59.2	25.1	15.7	6.7	35.9	15.2	99.4	42.2	27.1	11.	235.4
1978	+ 6.4	+ 2.1	63.7	21.5	19.5	6.6	51.4	17.4	116.8	39.5	37.9	12.8	295.6
1979	−13.4	− 3.9	110.9	32.5	25.1	7.3	53.9	15.8	119.5	35.0	45.6	13.3	341.6
1980*	−35.6	−13.3	125.9	47.1			57.6	21.5	119.6	44.7			267.4

*Provisional

Source: Central Statistics Office.

machinery accounted for two-thirds of overall capital formation. Another interesting fact illustrated by the table is the relative decline in the amount of capital invested in breeding stock and land improvement.

Agricultural Incomes

11. In the years prior to entry to the European Economic Community, the conditions under which international trade in agricultural products was conducted were generally unsatisfactory for the smaller agricultural exporting country such as Ireland. Export outlets for traditional suppliers were being curtailed, while increasing quantities of food were being introduced on to export markets by the larger producers — frequently at prices which were quite unremunerative. These problems persisted for many years and aggravated the difficulties for countries which relied heavily on agricultural exports for national development. As a result, the incomes of individual farmers in Ireland were severely curtailed by the effects of the international trading situation on the prices received for farm products.

12. The gap between agricultural incomes and other incomes narrowed considerably after we joined the EEC. However, recently the gap has begun to widen again due to rapid inflation in agricultural costs which have not been offset by a corresponding rate of increase in agricultural prices. Farm incomes fell from £834m in 1978, to £731m in 1979 and to £672m in 1980, a fall of 20 per cent over the two years. After allowing for the increase of 34 per cent in the Consumer Price Index, the fall in farm incomes in real terms between 1978 and 1980 was 40 per cent. When the decline in the farm labour force is taken into account, the fall in farm income per head in real terms was 38 per cent.

TABLE 26.5

Changes in Income Arising in Agriculture 1970-1980

Year	Income arising in Agriculture £m's	% change on previous year	Index of Total Farm Income in Real Terms 1970=100
1970	182.3		100
1971	200.3	+ 9.9	100.9
1972	283.9	+41.7	131.6
1973	363.1	+27.8	151.1
1974	330.4	− 9.1	117.6
1975	476.3	+44.5	140.4
1976	534.9	+12.3	133.6
1977	743.0	+38.9	163.3
1978	834.5	+12.3	170.2
1979	734.0	−12.0	132.2
1980*	672.0	− 8.4	102.4

Source: Irish Banking Review, September 1978 pp. 14-25, (E.A. Attwood) and *Irish Statistical Bulletin* July 1980.

*Provisional.

13. Table 26.5 illustrates the changes in incomes arising in agriculture during the 1970's. When expressed in real terms, farm incomes have fluctuated sharply from year to year with a strong underlying upward trend.

State Aid to Agriculture

14. The State makes a substantial direct contribution to the development of the agricultural sector. This is borne out by Table 26.6 which shows the level and pattern of direct Government expenditure in agriculture in each of the years 1973-1980. The table does not include expenditure by local authorities.

TABLE 26.6

State Expenditure in Relation to Agriculture 1973-1980

Category	1973 £000's	1974(a) £000's	1975 £000's	1976 £000's	1977 £000's	1978 £000's	1979 £000's	1980 £000's
1. Aids reducing production and overhead costs and production incentives	50,170	41,043	44,017	47,165	49,732	44,959	44,153	48,315
2. Schemes operated under EEC Regulations and Directives		4,395	16,877	35,235	40,340	48,588	54,611	85,025
3. Education, Research, Advisory and Inspection Services	11,082	8,381	15,156	19,299	24,771	29,688	24,967	33,394
4. Disease Eradicaiton	10,040	9,427	9,763	6,616	12,482	15,040	13,221	11,201
5. Long-term Development Aids	15,553	12,937	19,294	17,197	15,246	16,192	20,726	20,989
6. Marketing Aids	494	476	615	526	557	608	642	320
7. Administration of acts, regulations and schemes	1,633	1,415	2,847	3,319	b	b	b	b
8. General administration and overhead costs	c	c	c	13,058	12,945	14,967	18,971	25,060
Total	88,972	69,284	108,569	142,415	156,064	170,062	177,291	224,377

(a) 9 Months.
(b) From 1977 these costs have been distributed under appropriate heads above.
(c) These costs were not included in previous tables.
Source: Budget Booklets.

Table 26.6 shows that in 1980 expenditure on EEC related schemes accounted for 38 per cent of the total, production incentives (21 per cent), education and research (15 per cent), disease eradication (5 per cent) and long-term development aids (9 per cent). The amount expended on marketing aids was negligible.

APPENDIX 27

SYSTEMS OF VALUATION OF FARMING STOCK FOR TAX PURPOSES

1. In this appendix we set out various systems which could be used to value farming stock for tax incentives purposes. These are

(i) the New Zealand system of standard and nil values,
(ii) the United Kingdom herd basis and
(iii) stock relief.

New Zealand System

2. During the course of our review, we have examined the system of stock valuations in New Zealand. This enables farmers to adopt "standard values" for each class of livestock instead of any of the other options available for the valuation of other trading stock. Farmers may write down stock from purchase price to standard value progressively over three years. To the extent that market prices for livestock remain above standard value, every annual increase in livestock numbers adds to the "income reserve" represented by the difference between market values and standard values. This income reserve does not become subject to tax until it is converted to cash or the farmer dies and market values are adopted for income tax purposes at the date of death.

3. A refinement of the standard values system was introduced in New Zealand in 1966. This was the nil standard value scheme and it was adopted for the express purpose of maintaining the growth of livestock numbers. It was intended to be a taxation incentive to encourage increases in livestock numbers by deferring taxation resulting from increases in livestock. Under the scheme a base flock or herd is established by the farmer. Subsequent increases over the base numbers are shown at a nil standard value. The farmer has the option at any time of increasing the standard values for the extra livestock from nil to his actual standard values for each particular class of animal. If he does not exercise this option, the tax is deferred until he does or disposes of the livestock.

4. One problem encountered by the Revenue authorities in New Zealand has been the establishment of realistic standard values for livestock. For years many farmers had been using standard values which did not reflect the average price of the stock. This arose from the erosion of the original

values as a result of inflation. After protracted discussions with the industry, revised minimum standard values were established for new farmers (including sons who inherit farms). The new values are updated every three years. The problems in this area might be reduced if the standard values were indexed.

5. There are a number of disadvantages associated with the New Zealand system. Firstly, large contingent liabilities for tax are accumulated as a result of the nil value system. This causes little difficulty when stocks are being increased. However, when stocks are reduced, as they may have to be in times of recession, tax liabilities are generated at a time when farmers are in the worst possible position to meet them. This would not appear to be in the best interest of farmers. Secondly, the New Zealand provisions are also very complex and would need to be adapted to Irish conditions. Farmers would need some time to come to terms with the new system. Thirdly, the information on movements in stock numbers supplied by farmers to the Revenue Commissioners would have to be improved. We understand that sales of livestock in New Zealand are generally made through marts and returns of these are made to the Revenue authorities. Similar provisions might be required in Ireland before the standard and nil values could be implemented here.

United Kingdom Herd Basis

6. Generally, livestock kept by farmers and other traders is treated for the the purposes of United Kingdom income tax as "trading stock". However, farmers or traders can choose once and for all to have "production herds",[1] that is, herds of mature animals kept for the sale of their produce or progeny as opposed to slaughter, dealt with separately as capital assets, on what is commonly referred to as the "herd basis".

7. On the trading stock basis, the cost of animals acquired is deducted in the accounts and the price of animals sold is brought in as a receipt. The valuations of livestock on hand at the beginning and end of the account are included for tax purposes in arriving at the results of the trading. On the herd basis, the valuations of production animals are not taken into account in computing trading profits. In other words, the cost of the original herd or flock, or of additions to an existing herd or flock that increases its numbers, is not deductible. The herd basis, therefore, gives farmers an opportunity of having an eventual profit exempt from all taxes. In addition, it avoids tax on increases in annual valuations resulting from inflation.

[1]Herd or flocks, such as dairy herds or live flocks, that are kept for the sale of milk, young animals or other produce. It does not include herds of animals which are themselves intended for sale, e.g. cattle which are intended for sale although they meanwhile produce calves or milk for sale—such animals are treated on trading stock.

8. Under the herd basis, any profit on the sale of a whole herd or flock (or a substantial part of it), without replacement, will not be included in profits for tax purposes, nor will relief from tax be given in respect of any loss on such a sale. It should be noted, however, that a profit or loss on the sale of individual animals without replacement will be taken into account. Account will also be taken of the profit or loss on the sale of a small part of a herd or flock. Where animals in a herd are replaced, the sale proceeds of the old animals are included as a trading receipt and the cost of the animals added in replacement is deducted as an expense.

9. When a farmer elects to adopt the herd basis for the treatment of his production herd for tax purposes, it means that neither the initial cost of his herd, nor the cost of any animals added to his herd to increase its numbers, will be deducted as an expense in calculating his profit or loss. There are certain other conditions which apply when the herd basis is used. For example, when a farmer replaces an animal in his herd, the sale price of the old animal will be included and the cost of the new animal can be deducted in arriving at a profit or loss. But if the new animal is of better quality, the extra cost of the new animal due to the element of improvement will not be deducted. Again, if a farmer sells a herd and buys another herd of the same kind, the conditions of the herd basis apply only with regard to a herd of the same size and the same quality. If the new herd is larger than the old herd, the cost of the additional animals will not be deducted as an expense in the farmer's accounts.

10. If the whole of a herd is sold within a period of twelve months without replacement, any profit or loss on the sale will not be taken into account for taxation purposes. But if within five years of the sale the farmer begins to acquire a new herd, the new animals will be treated as replacing the old animals. The sale price for the old animals will, however, be credited in the accounts at the time when the new animals are acquired, although it may have been received much earlier.

11. Once a farmer has made an election for the herd basis, it will continue to apply to all production herds of the same class kept by him. Even more important is the fact that he will not be able to revoke the election in subsequent years. However, if he ceases to keep any production herd of that class for a period of at least five years, he will have a new right to make an election for the herd basis if he subsequently acquires a new production herd of the sale class.

12. In short, adopting the herd basis is a means whereby the initial cost of the herd, and of permanent additions to it, do not rank as a deduction and the value of the herd is not brought into closing stock. If there is a casual sale from the herd, the profit or loss is brought into account in the trading results. However, the outright sale without replacement of the

running down of the herd is an occasion when the gain or loss is not accounted for tax purposes.

Stock Relief

13. For 1982/83 farmers are entitled to claim 100 per cent relief in respect of increases in the value of livestock. The relief may result in large contingent liabilities for tax. One of the drawbacks with this relief is that, if stocks are reduced, there is a clawback of relief. A further difficulty, is that stock relief cannot be claimed in a year in which there is a loss even though stock values have increased.

APPENDIX 28

THE SYSTEM OF CAPITAL TAXATION IN IRELAND PRIOR TO 1975

1. Prior to the introduction of the new system of capital taxation proposed in the White Paper "Capital Taxation", 1974, the taxation of gifts and inheritances in Ireland was under three headings — estate duty, legacy duty and succession duty. The estate duty was chargeable on all property which changed hands on a death. The rates of duty were graduated without regard to the relationship between the deceased and the inheritors, according to the aggregate value of all the items of property which passed or was deemed to pass on a death. Legacy duty and succession duty, while fundamentally alike, were mutually exclusive and were never payable together on the same property. They were taxes on the acquisition of property by a beneficiary on the death of the owner and the rates were not graduated by reference to the value of the property. They depended solely on the consanguinity between the beneficiaries and the former owner of the property. A brief outline of the duties as they operated is given below.

ESTATE DUTY

(i) **Property which was liable**

—property of which the deceased was competent to dispose at his death, that is, his own "free estate", whether he actually disposed of it or not;

—property in which the deceased had an interest for his life;

—property transferred by the deceased, by way of gift, within five years of his death;

—annuities or other interests purchased or provided by the deceased to arise on his death.

(ii) **Property exempt**

—all property in an estate if the entire estate was valued at less than £10,000;

—settled property passing on the death of a surviving spouse;

—gifts made outside five years of the death;

—gifts to the State, whether made *inter vivos* or on death;

—gifts made for public or charitable purposes more than one year before the death of the deceased;

—gifts of less than £500 in the case of any one donee;

—gifts which are shown to be part of the normal and reasonable expenditure of the deceased;

gifts made in consideration of marriage up to £5,000 from parent to child and up to £1,000 in other cases;

—objects of national, scientific, historic or artistic interest, subject to certain conditions about subsequent sale;

—certain Government, municipal or State board securities if the deceased was not domiciled or ordinarily resident in the State.

(iii) Valuation for duty

Property liable to estate duty was valued at its open market value at the time of the death of the deceased. To this general rule, there were some important exceptions.

Purely agricultural property (that is, farm-land with a residence, out-offices or other buildings related to the use of the land for farming purposes, where no part of the open market value was attributable to buildings, development or mineral exploitation) was valued at twenty-five times the rateable value, less charges in any case where by using this method of valuation the net value of the total estate was less than £3,000. (If the land was sold, outside the family, within six years of the death, it became liable at its market value at the time of the death).

Stocks and shares of certain Irish quoted companies were valued at two-thirds of their market value.

Shares of a non-trading private company were valued at the sum which the owner would receive on a liquidation.

A sum of £7,500 was deducted from the value of each of

(a) the total of policies of life assurance maturing on the death

and

(b) the total of death benefits arising under superannuation schemes. Gifted property was valued as at the date of the gift.

(iv) Rates of duty

The scale of rates of estate duty are shown in Table 28.1.

TABLE 28.1

Rates of Estate Duty in 1975

Principal Value of Estate			Rate per cent
Exceeding	£10,000	and not exceeding £11,000	4
,,	£11,000	,, ,, ,, £12,500	6
,,	£12,500	,, ,, ,, £15,000	8
	£15,000	£17,500	10
	£17,500	£20,000	12
	£20,000	,, ,, £25,000	14
	£25,000	£30,000	16
	£30,000	,, ,, ,, £35,000	18
	£35,000	,, ,, ,, £40,000	21
	£40,000	£45,000	24
	£45,000	,, ,, ,, £50,000	27
	£50,000	,, ,, ,, £55,000	30
	£55,000	,, ,, ,, £60,000	33
	£60,000	£75,000	37
	£75,000	£100,000	41
	£100,000	,, ,, £150,000	45
	£150,000	£200,000	50
	£200,000	,, ,, ,,	55

Marginal relief was given to ease the transition from one rate to the next higher rate.

(v) Quick Sucession Relief

If property consisting of lands, houses or an unincorporated business had borne estate duty and duty again became payable in respect of such property within five years, the duty due on the second death was reduced:

by 50%	if	the	second	death	occurred	within	one	year	of	the	first
,, 40%	,,	,,	,,	,,	,,	,,	two	years	,,	,,	,,
,, 30%	,,	,,	,,	,,	,,	,,	three	,,	,,	,,	,,
,, 20%	,,	,,	,,	,,	,,	,,	four	,,	,,	,,	,,
,, 10%	,,	,,	,,	,,	,,	,,	five	,,	,,	,,	,,

(vi) Abatements of duty

Where property affected by a claim for estate duty passed to the widow or dependent children of the deceased, the amount of estate duty otherwise payable was reduced. If it passed to a widow who had no dependent children the reduction was £4,000. If it passed to a widow with dependent children there was a further reduction of £2,000 in respect of each dependent child. Property which passed directly to a dependent child carried an abatement of £2,000.

These abatements applied only to estates whose value did not exceed £100,000, with tapering relief for estates exceeding that value. So far

as a widow was concerned the thresholds which had to be reached before she became liable to estate duty were as follows:

If the entire estate passed to the widow and there were no dependent children £25,500

If the entire estate passed to the widow and there was one dependent child £33,333

If the entire estate passed to the widow and there were two dependent children £38,095

If the entire estate passed to the widow and there were three dependent children £41,666

If the entire estate passed to the widow and there were four dependent children £46,200

If the entire estate passed to the widow and there were five dependent children £50,500.

(vii) **Interest on duty in arrear**

Interest on unpaid duty on personal estate began to accrue at the expiration of four months from the date of death and interest on unpaid duty on real estate at the expiration of one year from the date of death. The rate of interest was 9 per cent per annum.

(viii) **Instalments**

Estate duty on real estate (that is, lands or house property other than leaseholds) could be paid by eight yearly or sixteen half-yearly instalments, the first instalment was due on the first anniversary of the death.

(ix) **Double Taxation Relief**

Estate duty was payable on all the property, wherever it was located, of persons who died domiciled in the State and on the property located in the State of persons who died domiciled abroad.

The foreign property of persons who died domiciled in the State could also be liable to estate duty in the country where it was located. To eliminate the taxation of property both here and in the country where it was located, reciprocal arrangements existed with certain countries whereby the country making the main charge for the duty gave credit for duty paid in another country in respect of assets situated in the latter country. The countries involved included the United Kingdom, USA, India, Pakistan, Australia, New Zealand and certain African States.

3. LEGACY DUTY AND SUCCESSION DUTY

(i) **Property which was liable to**

—Legacy duty: the personal estate, wheresoever situated, of a person who died domiciled in the State.

—Succession duty: all real property situated in the State passing under a will or intestacy or a settlement, irrespective of the domicile of the deceased: it was also payable on personal property which passed under a settlement if the "proper law" of the settlement was the law of the State or if the settlor was domiciled in the State when the settlement took effect. Estate duty payable in respect of property was allowed as a deduction from the value of such property for legacy and succession duty purposes.

(ii) **Property which was exempt**

—benefits taken by a surviving spouse, lineal issue or lineal ancestors;

—property derived under a will or intestacy where the total value of the estate did not exceed £10,000;

—property given for charitable purposes and applied for such purposes in Ireland.

(iii) **Rates of legacy and succession duty**

—property acquired by brothers or sisters or descendants of brothers or sisters or their spouses was liable at 10 per cent;

—property acquired by more distant relatives or strangers was liable at 20 per cent.

How Duties were Assessed

4. The scale of rates of estate duty set out above was referable to the total value of an estate, i.e. duty was assessed on the "slab" principle as distinct from the "successive slice" principle.[1] The result was that, while an estate under £10,000 was exempt, once the estate exceeded this figure, the entire estate was liable to duty at the appropriate rate. For example, an estate of £50,000 was liable at 27 per cent i.e. the duty payable was £13,500. If that estate passed to three people who were liable in equal shares for the duty, each person had to contribute one-third (£4,500) of the duty. If one of the persons was the widow of the deceased, her abatement of £4,000 reduced the liability to £500; in the case of a dependent child, liability was reduced to £2,500. If the estate passed to persons other than the spouse, lineal issue or lineal ancestors, legacy or succession duty was payable in addition to estate duty. Table 28.2 shows the duties which were payable on the estate of £50,000 in certain cases.

[1] A tax assessed on the slab principle charged the full amount of capital to the rate of duty appropriate to the band within which it fell *viz.*, an estate with a principal value of £38,000 fell into the 9th band for estate duty purposes which was subject to a rate of 21%. The tax payable was £7,980. A tax assessed on the slice principle would, on the other hand, charge each successive slice of capital at a separate rate. Assuming that the scale in paragraph 1 (iv) was a successive slice, the duty payable on an estate of £38,000 would be £3,910.

TABLE 28.2

Amount of Duty Payable in 1975 in Certain Cases on an Estate of £50,000

Passing to	Estate Duty Rate	Gross Estate Rate	Net Estate Duty	Legacy or Succession Duty	Total Duty	Effective Rate of Taxation
	%	£	£	£	£	%
Widow	27	13,500	9,500	Nil	9,500	19
Widow with 2 dependent children	27	13,500	5,500	Nil	5,000	11
Brother	27	13,500	13,500	3,650	17,150	34.3
Strangers	27	13,500	13,500	7,300	20,800	41.6

APPENDIX 29

CAPITAL ACQUISITIONS TAX

1. Capital acquisitions tax is made up of two parts: a gift tax on gifts taken on or after the 28 February, 1974 and an inheritance tax on inheritances taken on or after the 1 April, 1975. A gift is taken when a person becomes beneficially entitled in possession, otherwise than on a death, to property for which he does not provide full consideration in money or money's worth. A gift is a gratuitous acquisition of property. Broadly speaking, a person takes an inheritance when he becomes so entitled on a death, usually under a will, intestacy or a settlement. Gift tax is chargeable at 75 per cent of the rate applicable to inheritances. All gifts and inheritances made by a disponer to a particular beneficiary over his lifetime are cumulated. In the March, 1982 budget it was proposed that all gifts and inheritances received by a beneficiary from all sources would in future be aggregated to determine the tax liability on each benefit. The Finance Bill, 1982 modifies these proposals so that aggregation is to apply only to gifts and inheritances received in a particular class.

Territoriality

2. The entire property comprised in a gift or an inheritance is liable to the tax if, broadly speaking, either the disponer is domiciled in the State or the law governing the disposition is that of the State. If neither of these conditions applies, property is liable to the tax only insofar as it is situate in the State. The whole or part of the acquisition, thus ascertained as being liable to tax, is called a taxable gift or a taxable inheritance.

Exemptions

3. The most important of the exemptions are the four thresholds. Acquisitions up to the value of those thresholds are not liable to the tax which is chargeable only on the value in excess thereof. Amongst the other exemptions are

(i) the first £500 of the value of all gifts received in a year by a beneficiary from an individual disponer. The Finance Act, 1978 doubled the initial sum of £250;

(ii) superannuation benefits under approved schemes;

(iii) certain compensation payments or damages, prizes and winnings from lotteries;

(iv) normal and reasonable payments received by members of the donor's family in his lifetime for maintenance, support or education;

(v) gifts and inheritances for public or charitable purposes in Ireland;

(vi) works of art, scientific collections etc., of national, historic, scientific or artistic interest, kept permanently in the State and open to public viewing and houses and gardens of a similar nature subject to certain conditions including being open to public viewing.

Property Charged

4. Property comprised in an acquisition becomes charged to the tax only when the beneficiary becomes entitled thereto in possession. Future interests are not taxable until they fall into possession.

Value for Tax

5. The basis upon which tax is charged is the market value of the property comprised in the gift or inheritance. That value might be described as the price the property would fetch if sold on the open market on the valuation date in such a manner and subject to such conditions as might reasonably be expected to command the best price. The valuation date in the case of a gift is the date of the gift and, in the case of an inheritance, the date when the property has in fact been or is capable of being retained or set apart for the benefit of the successor.

Deductions

6. Deductions are allowable against the market value of the property for any liabilities or incumbrances to which the property was subject at the time of the acquisition (such as a mortgage or other subsisting charges) and for any which the beneficiary undertook to meet as part of the transaction (such as stamp duty, capital gains tax, costs and expenses). In addition, a deduction is allowable for any consideration provided by the beneficiary as a *quid pro quo* for the acquisition. The value thus arrived at is the taxable value of the taxable gift or the taxable inheritance as the case might be. In arriving at this value certain deductions such as the following are not allowable:

(i) contingency debts unless and until the contingency occurs;

(ii) liabilities for which reimbursement can be claimed;

(iii) liabilities created by the beneficiary, and

(iv) the tax on the gift or inheritance or the cost of raising the tax.

Agricultural Relief

7. This provides the only exception to the principle that the market value of property is the value for tax. In the case of agricultural property, the agricultural value, for the purposes of the Act, applies. That value is the market value reduced by the lesser of 50 per cent or £150,000. It has been proposed to increase the maximum deduction to £200,000 with effect from 1 April, 1982. Agricultural property means agricultural land, farm houses, buildings, trees and crops. The relief applies when the beneficiary is a farmer who is, by definition, an individual who is domiciled and ordinarily resident here. In addition, not less than 75 per cent of the market value of all his property, including the acquisition, must be represented by agricultural property and by livestock, bloodstock and farm machinery.

Tables of Rates

8. There are four tables of rates of tax (cf. paragraph 17 below) each referable to a class of beneficiary related respectively to the disponer as

(i) a spouse, child or minor child of a deceased child;

(ii) a lineal ancestor or lineal descendant (other than those at (i));

(iii) a brother, sister, nephew or niece, and

(iv) outside (i), (ii), and (iii).

Table 1 retains the original threshold of £150,000. The remaining three thresholds were doubled in the Finance Act, 1978, and now stand at £30,000, £20,000 and £10,000 respectively.

9. The excess over the thresholds is liable to tax. The rate of tax applied to the value of any acquisition is that which is referable to the highest part of the aggregate of all previous acquisitions and that acquisition.

10. Three categories of beneficiary are afforded special treatment to bring them within classes in which they would not otherwise qualify. The first is a widow or widower who is accorded the relationship of the deceased spouse to the disponer if that is nearer than his/her own relationship to him. The second is a beneficiary who is nephew or niece of a disponer and who has worked substantially on a full-time basis for the disponer for five years prior to the acquisition. The third is the grandchild of a disponer who is deemed to be his child in certain marriage settlements. Such beneficiaries are, subject to certain conditions, deemed to be a child of the disponer.

Assessment of Tax

11. The tax is assessed by the Revenue Commissioners on a return or additional return delivered by an accountable person. The Commissioners may require the return to be sworn. Assessments may be made by them in the absence of returns.

Interest

12. Interest is charged on outstanding tax at the rate of 1.25 per cent per month or part of a month. Interest is not charged where tax is paid within three months of the due date.

Instalments

13. The tax may, at the option of the taxpayer, be paid by five annual instalments with interest on the unpaid tax. This facility is not available in the case of an absolute acquisition of personalty.

Discretionary Trusts

14. The transfer of property into such trusts does not give rise to liability to the tax. The payment of the tax is postponed until beneficiaries become absolutely entitled in possession to any part of the trust property.

Life and Other Limited Interests

15. In such cases, the value for tax is the underlying property in which the interest subsists. This value is however discounted in accordance with the actuarial tables in the Act which have regard to the age and sex of the beneficiary and the duration of the interest.

Aggregation

16. Although they are not themselves chargeable to tax, all gifts taken by the beneficiary from the same disponer in the five years from the 28 February, 1969 to 28 February, 1974 are aggregated with all subsequent acquisitions taken by that beneficiary from that disponer.

17. The existing rates of capital acquisitions tax and the effective rates of tax which these imply are as follows.

Rates of Capital Acquisitions Tax

Class I

Applicable where the donee or successor is the spouse, child, or minor child of a deceased child of the disponer.

Portion of Value		Rate of tax
Lower Limit	Upper Limit	Per cent
£	£	
0	150,000	Nil
150,000	200,000	25
200,000	250,000	30
250,000	300,000	35
300,000	350,000	40
350,000	400,000	45
400,000		50

Class II

Applicable where the donee or successor is a lineal ancestor or a lineal descendant (other than a child or a minor child) of a deceased child of the disponer.

Portion of Value		Rate of tax
Lower Limit	Upper Limit	Per cent
£	£	
0	30,000	Nil
30,000	33,000	5
33,000	38,000	7
38,000	48,000	10
48,000	58,000	13
58,000	68,000	16
68,000	78,000	19
78,000	88,000	22
88,000	103,000	25
103,000	118,000	28
118,000	133,000	31
133,000	148,000	34
148,000	163,000	37
163,000	178,000	40
178,000	193,000	43
193,000	208,000	46
208,000	223,000	49
223,000		50

Class III

Applicable where the donee or successor is a brother or a sister, or a child of a brother or of a sister of the disponer.

Portion of Value		Rate of tax
Lower Limit	Upper Limit	Per cent
£	£	
0	20,000	[illegible]
20,000	23,000	[illegible]
23,000	28,000	12
28,000	38,000	[illegible]
38,000	48,000	19
48,000	58,000	23
58,000	68,000	27
68,000	78,000	31
78,000	93,000	35
93,000	108,000	40
108,000	123,000	45
123,000		50

Class IV

Applicable where the donee or successor does not stand to the disponer in a relationship referred to in Class II or III above.

Portion of Value		Rate of tax
Lower Limit	Upper Limit	Per cent
£	£	
0	10,000	Nil
10,000	13,000	20
13,000	18,000	22
18,000	28,000	25
28,000	38,000	30
38,000	48,000	35
48,000	58,000	40
58,000	68,000	45
68,000	83,000	50

Effective Rates of Capital Acquisitions Tax

Top of Slice	Class I		Class II		Class III		Class IV	
£	£	%	£	%	£	%	£	%
10,000			6,300	8.08	[illegible]	[illegible]	[illegible]	—
30,000			11,000	11.22	[illegible]	[illegible]	[illegible]	16.0
78,000			18,000	14.63	[illegible]	[illegible]	[illegible]	31.03
98,000			47,420	23.70	[illegible]	[illegible]	[illegible]	35.66
123,000			196,950	39.39	[illegible]	[illegible]	[illegible]	40.61
200,000	12,500	6.25	696,950	46.46	[illegible]	[illegible]	[illegible]	48.08
500,000	137,500	27.50	1,946,950	48.67	[illegible]	[illegible]	[illegible]	55.23
1,500,000	637,500	42.50	3,696,950	49.43	[illegible]	[illegible]	[illegible]	58.41
4,000,000	1,887,500	47.19	9,946,950	49.73	[illegible]	[illegible]	[illegible]	59.40
7,500,000	3,637,500	48.50	14,946,950	49.82	[illegible]	[illegible]	[illegible]	59.68
20,000,000	9,887,500	49.44	24,946,950	49.89	[illegible]	[illegible]	[illegible]	59.88
30,000,000	14,887,500	49.63			[illegible]	[illegible]	[illegible]	59.92
50,000,000	24,887,500	49.78			[illegible]	[illegible]	[illegible]	59.95

APPENDIX 30

WEALTH TAX

1. In this appendix we describe the main provisions of the Wealth Tax Act, 1975. The tax was charged on the taxable wealth of every assessable person. Taxable wealth was, broadly speaking, the net value of all the property to which an assessable person was beneficially entitled in possession. There were three categories of assessable persons, namely, individuals, discretionary trusts and private non-trading companies. The property of the wife and minor children of a married man was aggregated with his property and was treated as part of his taxable wealth. If the husband and wife were separated, the property of the wife was not aggregated with that of the husband and the property of a minor child was aggregated with that of the parent who had custody of that child. The tax was assessed after deducting the appropriate thresholds from the net market value of taxable wealth of the individual. These thresholds were £100,000 for a married couple, £90,000 for a widow or widower and £70,000 for all others. Where the wealth, if any, of minor children was aggregable, a further deduction of £2,500 was made in respect of each such child. These thresholds did not apply to the other assessable persons, namely, discretionary trusts and private non-trading companies. The tax was charged on the net market value of the taxable wealth of each assessable person (less the appropriate thresholds, if any) on every valuation date. The valuation date was 5 April each year, starting with 5 April, 1975. The net market value upon which the tax was chargeable was the market value less certain reliefs and deductions. The market value itself was, in general, the open market value but special provisions applied to the ascertainment of the market value of

(i) shares in a private trading company, which was controlled by an assessable person, and

(ii) certain agricultural land within a mile of an urban area.

Exemptions

2. Certain categories of property were exempted from wealth tax including

(i) a dwellinghouse to which an individual was entitled, together with its garden or grounds up to an area of one acre. To qualify for exemption, the dwellinghouse had to be occupied by the individual as his only or principal residence. If a part of the dwellinghouse was let or was used mainly for the purposes of a trade or business, such part was not exempted from tax;

(ii) furniture and household effects, being the normal contents of such a dwellinghouse;

(iii) livestock to which a farmer, as defined, was entitled;

(iv) bloodstock;

(v) the right to receive certain superannuation benefits or annuities;

(iv) growing timber in the State;

(vii) shares of a private non-trading company where the company was a taxable entity, and

(viii) heritage property and certain works of art.

Rate of Tax

3. The rate of tax[1] was 1 per cent of the net market value of the taxable wealth on the valuation date.

Reliefs for Productive Assets

4. Reliefs were provided for what was described as productive property. The relief took the form of a deduction from the market value of certain property to arrive at the net market value of that property, that is, the value upon which tax was assessed. There were two forms of relief, namely,

(i) a deduction of 50 per cent or £100,000 (whichever was the lesser) in respect of

(a) agricultural property and farm machinery. This relief was avail-

[1]The proposals in the White Paper on Capital Taxation published on 28 February, 1974 (Prl. 3688) as regards wealth tax were that tax should be charged annually on all property over £40,000 for a single person and over £60,000 for a married couple. The rates of tax would vary according to the amount of taxable net wealth, increasing from 1½ per cent. In an address to the Confederation of Irish Industry on 15 May 1974, the Minister for Finance announced a decision to modify the wealth tax proposals in the White Paper as follows:

(i) to apply a single rate of 1 per cent instead of rates of 1½ per cent up to 2½ per cent.

(ii) to increase exemption thresholds from £70,000 to £100,000 for a married man and from £40,000 to £70,000 for a single person, with an additional allowance for each minor child of £2,500 and a new exemption threshold of £90,000 for a widowed person;

(iii) to revise these thresholds every three years to take account of inflation — valuations initially agreed would remain valid for three years.

The first two of these items were later incorporated in the Wealth Tax Act, 1975.

able only to individuals who were domiciled and ordinarily resident in the State of whose gross wealth not less than 75 per cent consisted of agricultural property, farm machinery, livestock and bloodstock. For this purpose, agricultural property included woodland and farm buildings;

(b) fishing boats employed wholly in commercial sea fishing;

(c) so much of hotel premises as consisted of bedroom accommodation.

This relief was available only where the property in question was owned by an individual.

(iii) a deduction of 20 per cent from the market value of any other property in the State which was used directly in the provision of employment in the State and of stock or shares of a trading company.

5. Special provision was made for arriving at the market value of agricultural property which was situated within one mile of an urban area, where it was shown that its value was enhanced by it's high potential for development. In such cases, the market value was ascertained by adding 25 per cent to its agricultural value.

APPENDIX 31

THE DISTRIBUTION OF PERSONAL WEALTH IN IRELAND

1. In this appendix we review the available data on the distribution of personal wealth in Ireland and compare them to the official estimates of wealth distribution in the United Kingdom. We conclude that both sets of data are defective and do not offer the best foundations on which to base firm judgements about the distribution of wealth. We also look at certain adjustments to the data which produce a somewhat different picture of the spread of wealth.

Public Wealth

2. It is important to note that estimates of the distribution of personal wealth exclude wealth that is publicly owned. Public wealth in Ireland is substantial. For example, in 1978 the total assets of state-sponsored bodies in Ireland amounted to £3,985 million.[1] In addition, in 1979 there were almost 103,000 publicly owned houses let by local authorities. It may be argued that the greater is the share of public wealth in the economy, the less concern there needs to be about the distribution of personal wealth.

Distribution of Personal Wealth in Ireland

3. The latest information on the distribution of personal wealth in Ireland relates to 1965/66.[2] This information is based on official estate duty records supplied by the Revenue Commissioners. Lyons estimates that the distribution of wealth is as shown in Table 31.1.[3]

TABLE 31.1

Distribution of Personal Wealth in Ireland, 1965/1966

Population:	Top 1%	5%	10%	20%
Wealth:	Own 33.7%	63.0%	78.1%	93.2%

[1] Report No. 20 of Review Body on Higher Remuneration in the Public Sector, 1979 Prl 8184 Appendix 16 Table II. Gross domestic product in 1978 amounted to £6,721 million.

[2] P. M. Lyons "Estate Duty Wealth Estimates and the Mortality Multipliers," *Economic and Social Review*, Vol. 6, No. 3, pp. 337-353, April, 1975.

[3] The table is calculated from Table 3 in Lyons (1975, p. 344) and refers to the adult population (aged 20 and over).

Limitations of Estimates of Distribution of Wealth

4. The method used to produce estimates of the distribution of wealth from estate duty or inheritance tax records is called the "mortality multiplier" method. This begins by analysing all the estimates assessed for duty in the relevant year by age and sex of the deceased. To estimate total personal wealth among the living a "mortality multiplier" based on published statistics is applied to the assessments. The number of wealth-owners in each age and sex group are multiplied by the reciprocal of the appropriate mortality rate. If the number of deaths per 1,000 of population for a male age-group is 1 in 1,000, the number and value of estates in that group are multiplied by 1,000 to give an estimate of total wealth for the living population. Estimates of total wealth are thus constructed, together with analyses of numbers of owners of property in each range of wealth and of the value of each type of property.

5. This method has a number of well-known limitations. Firstly, there are normally very few deaths in certain categories. As a result, estates may not be representative of the whole population. Secondly, to appear in estate duty returns, wealth must have been owned by the deceased at the time of death and have a value after death, except for gifts *inter vivos*. This leads to differences between wealth for estate duty purposes and personal wealth in case of, for example, lifetime transfers, pensions and life insurance. Thirdly, the unit used for estate duty purposes is the individual not the family which, in our view, would be the appropriate unit for the purposes of examining the distribution of wealth. Fourthly, the estimates reflect the distribution of wealth at a particular moment in time. This distorts the picture because older people tend to have more wealth than younger people. A degree of inequality between younger and older people is not normally considered to be unjust, since it merely reflects the normal life cycle in which persons tend to accumulate property. Fifthly, the wealth owned by people at the lower end of the scale may be understated since valuations would not be queried by the Revenue Commissioners if there were no possibility of a tax liability.

6. There are also a number of limitations peculiar to the Lyons study which should be noted. Firstly, the data refer to the adult population (aged 20 and over). The high figures for groups such as the top 20 per cent reflect the fact that Lyons assumes that the part of the population which does not appear in the estate duty statistics has zero wealth. The result is that 38 per cent of the total adult population is estimated to own all personal wealth, leaving the remaining 62 per cent with nothing. Secondly, the mortality multipliers used by Lyons for his main set of estimates are those derived from the general population death rates. Since Lyons assumes that the wealth of each member of the excluded population is zero, the use of these

general mortality multipliers generates different percentage shares of top wealth-holders than multipliers adjusted for social class.

Adjustments to the Statistics

7. Due to the limitations on the value of estimates of the distribution of wealth compiled from estate duty statistics, it is clear that they cannot give a satisfactory indication of the degree to which the holding of wealth is concentrated. The Royal Commission on the Distribution of Income and Wealth in its Seventh Report[1] makes adjustments to the basic statistics to allow for the value of occupational and State pension rights. The results are shown in Table 31.2.

TABLE 31.2

Distribution of Personal Wealth in the United Kingdom, 1976

Percentage Shares of Estimated Personal Wealth by Given Quantile Groups of the Total Population Aged 18 and Over.

Quantile Group.	Unadjusted estimates	Including occupational pension rights	Including occupational and State pension rights
	%	%	%
Top 1 per cent	24.9	21.1	14.1
Top 5 per cent	46.2	41.2	29.1
Top 10 per cent	60.6	55.2	40.3
Top 20 per cent	77.6	72.6	55.3

8. The inclusion of the capital value of pension rights substantially reduces the inequality in the distribution of wealth. Even these adjustments do not allow for the wives and other dependants of wealth holders who are assumed to be propertyless. We believe that a good case can also be made for inclusion of the benefits of other Government expenditure, such as health, education, social welfare and housing benefits. Many of these are provided selectively to lower income groups and, if included, would substantially reduce the inequality in the published estimates of the distribution of wealth. The existence of rent-controlled dwellings in the private sector also reduces the inequality of wealth distribution.

Conclusion

9. The information on the distribution of wealth in Ireland is limited. Such information as exists is defective and exaggerates the extent to which the distribution of wealth is concentrated.

[1] Cmnd 7595 July, 1979 Chapter 4.

Wt. 134689. 5,000. 7/82. Cahill. (1434). G.16.