Income Tax

I. FISCAL AND ECONOMIC CONTEXT

1. The overall economic and fiscal context has been set out in the paper Economic Framework for the Budget (TSG 09/02).

II. PROGRAMME FOR GOVERNMENT AND THE COMMISSION ON TAXATION

2. An Agreed Programme for Government 2007 – 2012 set out guiding principles for economic and fiscal policy for the lifetime of the Government. The key principles and commitments in relation to personal taxation are attached at Appendix 1. Among the commitments in the Programme for Government was the establishment of a Commission on Taxation.

3. The Commission on Taxation was established in February 2008 and has recently reported to the Minister. The recommendations of the Commission on Taxation will be dealt with in a subsequent TSG paper in more detail.

III. REFORMS AND DEVELOPMENTS IN RECENT YEARS 2000 TO 2008

4. The income tax burden was reduced significantly in the years 2000 to 2008. The tax rates were considerably reduced and the standard rate band widened. The move from allowances to a more equitable tax credits system was completed in 2001 and in almost every year since then tax credits have been increased.

5. The standard tax rate was reduced from 22% in 2000 to 20% by 2001 while the higher rate was reduced from 44% in 2000 to 41% by 2007. The standard rate band was increased by 64% from €21,590 in 2000 to €35,400 in 2008. Since its conversion to a credit in 2001, the PAYE tax credit has increased by 260% from €508 to €1,830. The personal tax credit has increased by 31% in the same period. The other tax credits relating to specific circumstances of individuals were also increased significantly in this period.

6. The main thrust of tax policy in these years was:
    - To keep the minimum wage out of the tax net
    - To keep the average industrial wage out of the liability to pay tax at the higher rate
    - To keep the overall tax burden low to enhance the rewards for work.

7. By 2008 these goals had been achieved. The national minimum wage at €17,542 was below the entry point to income tax and PRSI at €18,300. The average industrial wage for 2008 (€34,431[1]) was well below the liability to tax

[1] Official C.S.O. figures for 2008 – released 7 August 2009

at the higher rate. By 2008 the data indicated that just under 40% of income earners were exempt from tax, just over 40% were paying tax at the standard rate and only 20% were paying at the higher rate.

IV. RECENT POLICY

Budget 2009 and Supplementary Budget 2009

8. In Budget 2009, due to the economic downturn and worsening public finances, an income levy was introduced. The income levy applied at 1% on income up to €100,100, at 2% on income above €100,100 but below €250,120 and 3% on income in excess of this amount. In Budget 2009 the standard rate cut off point was increased by €1,000 from €35,400 to €36,400 for single and from €44,500 to €45,400 for married one earners so as to ameliorate the effect of the income levy on middle income earners.

9. The continued deterioration in the public finances necessitated a Supplementary Budget in April 2009. The income levy rates were doubled and thresholds reduced. The Health Levy was doubled from 2% to 4% and 2.5% to 5% and the higher threshold reduced from €100,100 to €75,036. The PRSI ceiling was also increased from €52,000 to €75,036.

Income Levy, Health Levy & PRSI changes 2009			
	Budget 2008	**Budget 2009**	**Supp Budget 2009**
Income Levy (Medical Card Exempt)		**€**	**€**
Exemption Threshold (under 65) Exemption Threshold (individual 65+) Exemption Threshold (married couple 65+)	N/A N/A N/A	18,304 20,000 40,000	15,028 20,000 40,000
Middle Rate Threshold	N/A	100,100	75,036
Higher Rate Threshold	N/A	250,120	174,980
Lower Rate	N/A	1%	2%
Middle Rate	N/A	2%	4%
Higher Rate	N/A	3%	6%
Health levy (Over 70 or Medical Card Exempt)	**€**	**€**	**€**
Exemption Threshold	26,000	26,000	26,000
Higher Rate Threshold	100,100	100,100	75,036
Lower Rate	2.0%	2.0%	4.0%
Higher Rate	2.5%	2.5%	5.0%
PRSI (Over 66 Exempt)	**€**	**€**	**€**
PRSI Ceiling	50,700	52,000	75,036

10. The changes introduced in Budget 2009 and Supplementary Budget 2009 have reduced the take home pay of almost all earners in all categories. The single earner on the average industrial wage has seen a 4.6% reduction in take home pay since Budget 2008. The married one income earner on the average industrial wage has seen a 0.9% reduction in take home pay. The changes were progressive with high earners seeing the biggest reductions. Single earners on €100,000 and €200,000 saw reductions in take home pay of 8.2% and 10.2%, respectively and married one income earners on these levels of income saw reductions of 7.7% and 9.8%. Only at very low levels of pay where the Budget 2009 increases in family income supplement (FIS) payments come into play is there an evidence of increases since Budget 2008. (see table below) Supplementary Budget 2009 has brought those on the minimum wage back into the tax net (income levy only).

Single		Budget 2008	Budget 2009	Supp Bud 2009	Difference on Budget 2008
	Gross	Net	Net	Net	%
National Min Wage	**€17,542**	€17,542	€17,542	€17,191	-2.00%
Average Industrial Wage	**€32,580**[2]	€28,033	€27,708	€26,730	-4.65%
1.67 AIW	**€54,409**	€40,325	€39,946	€38,229	-5.20%
2 AIW	**€65,160**	€46,413	€45,924	€43,497	-6.28%

Married 1 Earner		Budget 2008	Budget 2009	Supp Bud 2009	Difference on Budget 2008
2 Children[3]	Gross	Net	Net	Net	%
National Min Wage	**€17,542**	€24,822 (Inc FIS)	€25,446(Inc FIS)	€25,303 (Inc FIS)	1.95%
Average Industrial Wage	**€32,580**	€30,763	€31,478 (Inc FIS)	€30,500 (Inc FIS)	-0.86%
1.67 AIW	**€54,409**	€44,945	€44,566	€42,849	-4.67%
2 AIW	**€65,160**	€51,033	€50,544	€48,117	-5.71%

Income Levy Base

11. The income levy has a broad base compared with income tax. Certain incomes and payments that are exempt from income tax are not exempt from the income levy. These include for example: income from patent royalties, payments from woodlands and the exempt earnings of writers, composers and artists. The levy also applies before the deduction of capital allowances, relief for pension contributions, double rent allowance, film relief, donations or property based reliefs.

12. The income levy was designed in this way to maximise the yield while at the same time preventing income earners from sheltering income through capital allowances, pension contributions or other methods.

13. The structure of the income levy has come under criticism from Farming Groups and the opposition because of the non-deductibility of capital allowances before the application of the income levy, specifically, capital allowances in relation to capital projects undertaken to comply with the Farm Waste Management Scheme which were mandatory on the farming sector. Life assurance groups and the opposition have also criticised the income levy

[2] Average Industrial Wage forecast for 2009
[3] Child Benefit or Early Childcare Supplement payments not included

because it applies to the employers' contribution to personal retirement savings accounts (PRSAs).

V. IMPACT OF BUDGET AND SUPPLEMENTARY BUDGET 2009

Marginal Tax Rates

14. The Marginal tax rate is described as the tax rate that applies to the last euro of the tax base. Marginal tax rates are important because they influence individual decisions to work more or indeed to work at all. The OECD working paper Tax and Economic Growth indicates that *"there is also the possibility that high top marginal rates will increase the average tax rates paid by high-skilled and high-income earners so much that they will migrate to countries with lower rates resulting in a brain drain which may lower innovative activity and productivity"*. Higher marginal tax rates for earners may also incentivise a greater level of tax evasion and contribute to the development of a shadow economy.

15. The measures undertaken in Budget 2009 and Supplementary Budget 2009 increased marginal tax rates significantly. After Budget 2008 the marginal tax rate for income earners on the average industrial wage and twice the average industrial wage was 26% and 43%, respectively. After Budget 2009 and Supplementary Budget 2009 these rates have increased to 30% and 51%, respectively. The highest marginal tax rate in Ireland, which is applicable on incomes over €174,980, is now 52%, compared with 43.5% in 2008.

Distribution of Income Earners

16. Preliminary forecasts are for continued decreases in numbers in employment and decreases in wage levels into 2010. This would have an effect on the distribution patterns of income tax payable for income earners in 2010. The likelihood is that more income earners would be exempt from income tax and fewer would be paying tax at the higher rate in 2010.

Income Tax Distribution of Income Earners 2009

Gross Earnings	% Income Earners	% Tax Paid
> €200,000	1%	26%
> €100,100	4%	48%
> €75,000	8%	62%
> €50,000	19%	82%
< €50,000	81%	18%

- The above table is derived from the latest data from the Revenue Commissioners, which takes account of the most up to date macroeconomic factors.

International Context/Tax Wedge

17. Ireland is almost unique in Europe in raising taxes on labour in response to the recent economic downturn. The majority of EU -27 countries reduced income taxes or consumption taxes (see Appendix 2)[4]. The United Kingdom

[4] Excerpt from European Commission – *Taxation trends in the European Union 2009 Edition*

increased personal income tax allowances as well as temporarily reducing VAT and temporarily exempted purchases of residential property from Stamp Duty. However, it has been announced that a 50% personal income tax rate will apply on incomes above £150,000 in the UK from April 2010.

18. According to the latest OECD Taxing Wages report, based on wage and tax levels for 2008, Ireland had the third lowest tax wedge[5] in the entire OECD for a single worker on average income (22.9%) and the second lowest tax wedge in the OECD for a married one income family with two children on average income (5.5%). Ireland has the lowest tax wedge in both categories of the EU group of members of the OECD. Ireland has maintained this low tax wedge over the last number of years.

19. The tax increases in Budgets 2009 and Supplementary Budget 2009 have increased our tax wedge. However, it would seem that we are still in a good position compared with our competitors in the OECD. After the tax increases in the two recent Budgets and assuming no tax reductions in other states, our tax wedge is still the third lowest in the OECD for a single worker on average income (26.5%) and still the second lowest for a married one income family with two children on average income (9.0%). See Appendix 3a and 3b

Replacement Rates

20. Replacement Rates are the relative difference between an individual's income when unemployed and their income when employed. Recent calculations of replacement rates found that the replacement rates in Ireland are high, over 70%, for married one income couples with 1, 2 or 3 children on the average industrial wage. Higher replacement rates occur at the lower income levels. Married one income earners with 1, 2 or 3 children on the national minimum wage or 2/3rds the average industrial wage have replacement rates between 80% and 90%. The highest replacement rate of 107%, was for a married couple with no children on the national minimum wage. These data are shown in Appendix 4.

21. These calculations did not take account of the monetary benefits of the medical card or rent/mortgage supplement which would further increase the replacement rates.

22. It is clear from the findings that an increase in Social Welfare rates or an increase in taxes would increase replacement rates, and a simultaneous increase in both, as happened in Budget 2009, would increase replacement rates still further.

VI. ISSUES FOR 2010 ARISING FROM COMMISSION ON TAXATION

Rationalise Levies into Income Tax System

23. The Minister has indicated that he would like to rationalise the income and health levies into the income tax system.

24. Absorption of the levies into the income tax system could be achieved in a number of ways by adjusting the standard rate and higher rate. Examples are set out below.

[5] The tax wedge is defined as income tax plus employee and employer PRSI as a proportion of gross wages plus employer PRSI

Levy	New Income Tax Rates
Income Levy (€1.6bn)	Standard Rate (+2%) 22% Higher Rate (+5.5%) 46.5%
Health Levy (€2.2bn)	Standard Rate (+3%) 23% Higher Rate (+6.5%) 47.5%
Income Levy and Health Levy (€3.8bn)	Standard Rate (+6%) 26% Higher Rate (+9%) 50%

25. Absorption of the levies into the income tax system would result generally in a 1%-3% reduction in take home pay across national minimum wage, average industrial wage, 1.67 times the average industrial wage and twice the average industrial wage. (see Appendix 5). This approach would affect married one income earners more than single individuals. The raising of the standard rate would also bring the minimum wage into the income tax net. High earners, those earning over €300,000, would actually see a small benefit from this measure. Marginal rates would increase for most income earners but particularly for the lower paid. Marginal rates for a single income earner on the national minimum wage would increase from 2% to 26%. Marginal rates for the average industrial wage would remain at 30% but marginal rates for twice the AIW would increase from 51% to 54%. Marginal rates for high earners, earning over €175,000, would actually decrease from 52% to 50%.

Third Rate of Tax

26. The case for the introduction of a third rate of income tax has been advanced from a number of quarters. The Department has been discussing with the Revenue Commissioners the practical implications of introducing a third rate of income tax, particularly in relation to timing, costs and the income tax structure.

27. The introduction of a third rate of income tax would require extensive software development work by Revenue. There would also be major timing and cost implications for payroll companies. The Payroll Software Association of Ireland has written to the Department asking for a 12 month notice period for major changes to the income tax structure. A successful implementation by January 2010 would be unlikely given the short time scale.

28. Revenue are already investing in developing the capacity for a third rate of tax to facilitate the introduction of a third rate, if required. The payroll companies on the other hand could not be expected to make any investment in dealing with a third rate without a clear indication from the Government that a third rate will be introduced.

29. A third rate of income tax would represent a major structural change in the income tax system. A third rate of tax would require a new second band. Transferability between spouses over different rates and bands would have to be clarified. This would add significant complexity to an already complex system. There are also issues in relation to tax reliefs. Tax reliefs are currently available at the standard rate or the marginal rate. A new rate would give incorrect results in many cases.

Individualisation

30. The aim of the "individualisation" process is to provide each person with their own non-transferable standard rate band. This involves narrowing the gap

between the single and married one earner band. At the end of the process, the single band will be the same as the married one-earner band and each spouse in a married couple will have the same non-transferable standard rate band.

31. When announced in Budget 2000, the stated purpose of individualisation was, essentially, to ease the burden on single persons (65% of the work force), to take workers on the average industrial wage out of the higher rate of tax and more generally to facilitate a reduction in the numbers paying tax at the higher rate. With the move subsequently to a tax credit system and substantial band widening these aims were achieved. However, the band system is currently a hybrid, partly individualised, with the gap between the single and married one earner at €9,000; the second earner in a married two earner couple has their own non-transferable standard rate band of €27,400.

32. The married two earner band is double the value of the single band and it has to be at least that. This is in line with the principle in the Murphy judgement which is that a married two-earner couple cannot be treated less favourably for tax purposes than two single persons with the same incomes as the spouses in the married couple.

33. Current Band Structure
The current band structure is as follows:

Single €36,400
Married One Income €45,400
Married Two Income €72,800 (with maximum transferability between spouses of €45,400).

34. <u>To complete individualisation</u>
Completing the process would result in the following structure:
Single €45,400
Married One Income €45,400
Married Two Income €90,800 (i.e. €45,400 for each spouse with no transferability between spouses).

35. This would be very costly to achieve, given that it would involve increasing the single band and the bands for married two earners. Married one earners would lose out in relative terms. The cost was estimated to be <u>over €800 million in a full year</u> prior to Budget 2009 (this amount would be roughly 20% lower given economic developments).

36. <u>To reverse individualisation</u>
Reversing individualisation would give the following structure:

Single €36,400
Married One Income €72,800
Married Two Income €72,800 (with full transferability between spouses).

37. This is even more costly to achieve as it involves a significant increase in the married one earner band. The cost was estimated to be <u>about €900 million in a full year</u> prior to Budget 2009 (this amount would be roughly 20% lower given economic developments).

38. The above illustrations assume that there are no reductions in the bands and that nobody would lose out other than in relative terms. Progress on individualisation has been slow, given the major costs and the objections raised in relation to those who lose out in relative terms, the married one earners.

39. As it currently stands, the band system is complicated and does not lend itself to change, for example, as discussed above, the introduction of additional rates (either at the bottom or at the top) because of the transferability issues that arise. In current circumstances, where increases in taxation for all are in prospect, there may be an opportunity, either to finalise the individualisation process or to reverse it on a cost neutral basis for the Exchequer. However, either approach would be very controversial.

Taxation or Means Testing of Child Benefit

40. In the Supplementary Budget 2009 the Minister stated that available resources should be targeted at those most in need, that the Government thought it was not fair to pay the same benefit irrespective of the level of income of the recipient and that for this reason the Government had decided that child benefit would be means tested or taxed in the next Budget.

41. Child benefit will cost approximately €2.5bn in 2009. This is a very significant burden on the Exchequer in times of reducing revenues. Child benefit has increased significantly since the late 1990s. Rates for the first and second child have increase by well over 300% from 1997 to 2008 while the cost of living has increased by less than 50% in the same period. Child benefit is paid to every recipient in full irrespective of income of the recipient or the total family income. The question of taxing child benefit has been considered a number of times in the past by the Department of Finance.

42. Since the announcement in the Supplementary Budget 2009 an inter-departmental group comprising representatives of the Department of Finance, the Department of Social Community and Family Affairs and the Revenue Commissioners has been discussing how best to tax or means test child benefit. There has also been ongoing consultation with the Office of the Attorney General.

43. The group considered that the first and crucial step in taxing or means testing the child benefit would be to establish the “ownership” of the benefit beyond doubt. This would involve changing the nature of the benefit in social welfare law such that the ownership of the benefit would reside with the individual(s) responsible for the care and custody of the child.

44. The group arrived at 4 options for the taxation or means testing of child benefit assuming that the ownership issue were resolved as suggested. Each has advantages and disadvantages in relation to yield, timing costs, difficulty, labour market impacts and equity considerations. The 4 options are set out below:

- Option 1 – Deduction at source

  This option treats child benefit as income that is within the scope of the PAYE system and provides for deduction of tax at source on payment. The Department of Social and Family Affairs (DSFA) would effectively act as an employer and use a payroll system to pay child benefit deducting the tax due where necessary.

- Option 2 – Coding In
  Under this option tax would be collected by reducing the individual's tax credits by the amount of child benefit. To ensure higher rate taxation in appropriate cases, the standard rate cut off point would be reduced by amount of child benefit paid.

- Option 3 – Hybrid system
  DSFA would deduct 20% of the child benefit at source and Revenue would collect additional tax due from higher rate taxpayers.

- Option 4 – Means Testing
  Under this option Revenue would supply the latest income data to DSFA. DSFA would reduce the child benefit payment on a scale in accordance with the income levels. This option essentially proposes an 'income test' based on Revenue records and should not be confused with the very thorough standard DSFA means test.

45. While all the options above have advantages and disadvantages, it is believed that they can all be realised given adequate time and resources. The Review Group on Public Expenditure and Public Service Numbers and the Commission on Taxation also have made recommendations in the area of child benefit.

VII. FURTHER OPTIONS

46. The options available within the income taxation system are constrained by yields attributable to rate increases and band/credit reductions. The estimated yields for a sample of measures is set out below.

Income Levy	**First Year**	**Full Year**
1% increase in Income Levy Rates	€m	€m
Increase 2% rate to 3%	413	573
Increase 4% rate to 5%	28	45
Increase 6% rate to 7%	21	42
Total	462	660
Income Tax	**First Year**	**Full Year**
	€m	€m
Standard Rate		
1% point increase	307	420
2% point increase	614	840
3% point increase	921	1260
Higher Rate		
1% point increase	98	145

2% point increase	196	290
4% point increase	392	580
6% point increase	588	870
PAYE Tax Credit		
€50 reduction	42	54
€100 reduction	84	108
€200 reduction	168	216
Personal Tax Credit[6]		
€50 reduction	56	78
€100 reduction	112	155
€200 reduction	224	310
Standard Rate Band		
€100 reduction	8	10
€500 reduction	39	52
€1000 reduction	76	102

Health Levy	**First Year**	**Full Year**
	€m	€m
Increase 4% rate to 5% and 5% to 6%	365	522

The Tax Strategy Group may wish to discuss.

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[6] Includes commensurate reductions in Married persons credit, widowed persons personal credit and lone persons credit.