

**Number of income earners who actually *pay* income tax
at the higher rate**

A paper prepared in Revenue is attached for the information of the TSG. The paper suggests that some persons classified as higher tax rate taxpayers may, because of the action in their favour of the application of tax credits, in fact have an overall tax of only 20%. Thus, very many '42%' taxpayers effectively pay tax at a much lower rate – arguably 'at 20%' - albeit that there is a 42% charge on their marginal earnings. The question arises whether this presentation of the facts will be of assistance in explaining the impact of the tax system to members of the public.

On the one hand

- The actual tax *paid* does not exceed the amount payable at the standard rate.
- The liability to *pay* tax at 42% is arguably notional rather than real in many cases, and there is therefore an 'overestimate' in many people's minds as to the prevailing tax levels.

However

- Tax is actually calculated at the marginal rate of 42% before the credit applies, and
- The credit and allowance systems are not directly comparable. The credit is independent of the rate of tax; it is a tax relief to which taxpayers are entitled (and which will reduce their net liability) regardless of the rate at which their gross liability is calculated; and it may therefore be overstating the case to treat tax credits as effectively covering the 42% tax calculated for c.250,00 taxpayers.

Number of income earners who actually *pay* income tax at the higher rate

1. Summary

1.1 An objective of An Agreed Programme for Government is to “*ensure that 80% of all earners pay tax only at the standard rate*”.

1.2 Moving from tax-free allowances to tax credits as the principal mechanism for delivering the basic personal reliefs from income tax may have obscured progress made towards that objective of ensuring that 80% of all earners pay tax only at the standard rate:

Tax-free allowances worked by reducing the amount of taxpayers’ income charged to tax, thereby increasing the number of taxpayers with no liability at the higher rate. In delivering tax relief of equal value, the tax credit system allows a greater amount of income to be charged— which initially produces additional liability, including liability at the higher rate. This additional gross liability to tax is then reduced or eliminated, in net liability and *payment* terms, by set-off of the tax credits.

1.3 Figures, as currently presented, focus on *gross liability* at the higher rate— although the *net* charge may not exceed 20%. A fuller picture (arguably, more accurately reflecting the terms of the Government objective) might be provided if, in addition, figures could also be presented showing those earners whose liability to tax at the higher rate is fully offset by deductible tax credits as earners who actually *pay* tax only at the standard rate.

1.4 For 2007, before Budget changes, this would mean that

- while 65.3% of income earners would be shown as having *liability* only at the standard rate,
- the percentage of earners shown as *paying* tax only at standard rate would increase to 76.8%.

2. For how many income earners is liability to income tax at the higher rate fully offset by their personal tax credits?

2.1 An Agreed Programme for Government

With regard to taxation, An Agreed Programme for Government states:

The parties remain committed to the achievement of the taxation objectives set out in Action Programme for the Millennium. Over the next five years our priorities with regard to personal taxation will be:

- *to achieve a position where all those on the national minimum wage are removed from the tax net, and*
- *to ensure that 80% of all earners pay tax only at the standard rate,*
- *to use the potential of the tax credit system to effectively target changes and to pursue further improvements in the income tax regime if economic resources permit.*

The move to tax credits in place of tax-free allowances, as a means of giving personal reliefs from income tax has, arguably, had the effect of obscuring progress made on the second objective above, i.e. “to ensure that 80% of all earners **pay** tax only at the standard rate”.

Tax-free allowances worked by reducing the amount of a taxpayer’s income charged to tax, thereby increasing the number of taxpayers with no liability at the higher rate. In delivering tax relief of equal value, the tax credit system first allows a greater amount of the taxpayer’s income to be charged - which produces additional liability, including liability at the higher rate. This additional *gross liability* is then reduced or eliminated in *net liability* and *payment* terms by set-off of the tax credits.

Appendix 1 sets out an example of both the allowance and tax credit approaches.

2.2 Numbers as currently presented

Based on the latest historical data on incomes (2003) as projected forward to 2006 income levels and numbers at work, an estimated **31.7%** of income earners (683,700 out of a total of 2,160,500 earners) are *liable* to income tax at the higher rate for 2006. The corresponding projected figure for 2007 on a pre-budget basis is that **34.7 %** of income earners are liable to tax at the higher rate (768,200 out of a total of 2,214,700 earners) and, accordingly, that 65.3% are liable only at the standard rate.

2.3 Allowances system of basic personal tax reliefs

In the operation of the personal *allowance* or “tax-free allowance” system (which applied *before* the introduction of standard-rated relief and, then, personal *tax credits*), taxable income, i.e. the income actually charged to tax whether at the standard rate or the higher rate, was arrived at after deduction of the personal allowances.

In the personal *allowances* system, budgetary increases in (1) personal allowances and (2) the standard rate bands both had the effect of slowing down the movement (due to annual income increases) of income earners into higher rate tax. This was the case because personal allowances ensured that a specified amount of income was neither chargeable to tax at the standard rate nor at the higher rate, i.e. income up to the amount of the personal or “tax-free” allowances was not charged to tax at all. The effect of the standard rate band was to specify a further amount of income that was only to be charged at the standard rate. Under the *allowances* system, therefore, personal allowances and the standard rate band had the same effect as respects the charge at the higher rate— they prevented it. Accordingly, it was the aggregate value of personal allowances and standard rate band that determined the point in a person’s income at which the higher rate of tax first applied.

In summary, as respects preventing income being charged at the higher rate, (1) personal or “tax-free” allowances and the standard rate band had the same effect and (2) an amount equal to the *sum* of the personal allowance *added* to the rate band was protected from the higher rate charge.

2.4 Tax credits system of basic personal tax reliefs

Under a *tax credits* system, however, only increases to the standard rate band can *obviously* achieve the effect of taking the higher rate out of play. This is because tax credits give relief by reducing the tax payable rather than by reducing the amount of income (“taxable income”) on which tax is charged at the standard and higher rates. The figure for taxable income is increased by the amount of income previously covered by allowances. The tax credits are deducted from the tax charged on that increased income rather than from the income itself.

The significance of this for present purposes is that, under the current tax credits system, income earners **who have the higher rate tax charged on their income reduced to Nil by set-off of their personal tax credits** are, nonetheless, included in the statistics as higher rate taxpayers. While the significant increases in personal and PAYE tax credits over successive Budgets have reduced individual income tax bills significantly, providing relief by tax credits rather than tax-free allowances has also conveyed the contrary impression of an increasing percentage of income earners paying tax at the higher rate.¹

2.5 In addition to data as currently presented, should numbers also be presented by reference to higher rate tax that, after set-off of personal tax credits, is actually paid?

In measuring the progress towards the objective of ensuring that 80% of income earners *pay* tax only at the standard rate it is not unreasonable to regard earners

- who have had an amount of tax calculated at 42%
- but for whom that amount is less than, and fully covered by, the personal tax credits that are deducted in arriving at the tax they actually have to *pay*,

as actually *paying* their tax only at the standard rate, rather than at the higher rate as well.²

2.6 What would the revised numbers be?

An estimate has been made of the numbers of income earners whose *taxable income* falls between

- the limit of their standard rate band and
- the amount of income up to which higher rate tax is fully offset by their main personal tax credits (which include the employee credit in the case of PAYE earners).

This estimate shows that some **254,531** income earners³, or **11.5% of all income earners** on tax records, are in this position of having sufficient tax credits to offset any liability they have at the higher rate. Excluding these from the higher rate numbers would mean that the estimated proportion of income earners for 2007, before any Budget changes, who *pay* some tax at the higher rate would be confined to **23.2%** of all income earners.

On that basis, before any Budget changes, 76.8% of all 2007 earners will pay tax only at the standard rate.

¹ There is no dispute that taxpayers with standard rate liability that is fully covered by tax credits should be categorized as exempt (or in the words of *An Agreed Programme for Government* “removed from the tax net”) rather than as being liable to tax at the standard rate. While the percentage of income earners classified as exempt has grown due to increases in tax credits, the effect of those credits in also eliminating higher rate tax liabilities is not similarly acknowledged.

² In an equivalent allowances-based system these taxpayers would have paid exactly the same amount of tax but none of it at the higher rate.

³ A married couple who have elected or have been deemed to have elected for joint assessment is counted as one tax unit.

Effect of equal relief being delivered by (1) Tax Credit and (2) Tax-free Allowance**(1) Tax Credit**

	€
Taxable Income	35,880
Tax	
32,000 @ 20% =	6,400
3,880 @ 42% =	<u>1,629</u>
Gross Liability	8,029
Less Tax Credit	<u>1,630</u>
Net Liability/Payment due	6,399

Despite the charge at the higher rate the tax paid is less than the standard rate tax of €6,400.

(2) Tax-free Allowance

[A tax credit of €1,630 is equivalent to a tax-free allowance (deductible from income that would otherwise be charged at 42%) of $€1,630 \times 100/42 = €3,880$.]

	€
Income	35,880
Less Tax-free Allowance	<u>3,880</u>
Taxable Income	32,000
Tax	
32,000 @ 20% =	6,400
NIL @ 42% =	<u>NIL</u>
Net Liability/Payment due	6,400

There is no charge at the higher rate and the same net tax is paid as in the tax credit system example above.

Although both taxpayers get the same relief from income tax and pay no more than standard rate tax, currently the tax credits taxpayer is regarded as a higher rate taxpayer.

Numbers

pre-Budget 2007 (base 2003)

	SINGLE	WIDOWED	MARRIED 1E	MARRIED 2E	TOTAL
PAYE	141,965	5,649	38,485	46,292	232,391
SCHEDULE D	6,558	880	7,052	7,650	22,140
ALL	148,523	6,529	45,537	53,942	254,531

These are the numbers of income earners whose taxable income falls between

- the limit of their standard rate band and
- the point of income at which their tax at the 42% rate would be offset by their basic personal tax credits (which include the employee credit in the case of PAYE earners)

The limits of standard rate bands and relevant income points are as follows:

Marital Status	Limit of Standard Band	Income Limit at which 42% tax is offset by credits
€	€	€
Single PAYE	32,000	39,429
Widowed PAYE	32,000	40,619
M1E PAYE	41,000	52,310
M2E PAYE	64,000	78,857
Single SCH.D	32,000	35,881
Widowed SCH. D	32,000	37,071
M1E SCH. D	41,000	48,762
M2E SCH. D	64,000	71,762

Calculation of the amount of income up to which higher rate tax is fully offset by basic personal tax credits

Marital Status	Limit of Standard Band	Calculation of amount of income up to which 42% tax is offset by credits
€	€	€
Single PAYE	32,000	$32,000 + [(1,630 + 1,490) \times 100/42] = \mathbf{39,429}$
Widowed PAYE	32,000	$32,000 + [(2,130 + 1,490) \times 100/42] = \mathbf{40,619}$
M1E PAYE	41,000	$41,000 + [(3,260 + 1,490) \times 100/42] = \mathbf{52,310}$
M2E PAYE	64,000	$64,000 + [(3,260 + (1,490 \times 2)) \times 100/42] = \mathbf{78,857}$
Single SCH.D	32,000	$32,000 + [1,630 \times 100/42] = \mathbf{35,881}$
Widowed SCH. D	32,000	$32,000 + [2,130 \times 100/42] = \mathbf{37,071}$
M1E SCH. D	41,000	$41,000 + [3,260 \times 100/42] = \mathbf{48,762}$
M2E SCH. D	64,000	$64,000 + [3,260 \times 100/42] = \mathbf{71,762}$