TSG 10/18

Tax Strategy Group

Corporation Tax

Introduction

1. This paper deals with the significant current issues relating to Corporation Tax (CT). It sets out recent trends in the yield from CT and deals with the background to and importance of maintaining our single low rate of CT on trading income. The paper outlines briefly the areas that might be considered through which changes in the CT regime could make a contribution to reducing the fiscal deficit. Finally, the paper sets out the main developments in the CT regime in recent years and discusses the potential for further change in these areas to facilitate economic growth.

Trends in yield from Corporation Tax

2. The tax yields from Corporation Tax from 2002 to 2009 are set out below.

Year	Yield €m	Proportion of total tax yield
2002	4,083	16.4%
2003	5,161	16.1%
2004	5,332	15.0%
2005	5,492	14.0%
2006	6,683	14.7%
2007	6,391	13.5%
2008	5,066	12.3%
2009	3,900	11.7%

3. Exchequer receipts from Corporation Tax have dropped by close to 40% in the period between 2007 and 2009. In the same period, the economy has contracted by 11% in GDP terms (14% GNP). While the higher rate of reduction in CT receipts would also reflect price effects in the economy, the significant downturn in receipts shows up the strongly pro-cyclical nature of Corporation Tax.

Brief background to and importance of maintaining the 12.5% CT rate

4. Recently, comments by the European Commissioner Olli Rehn were interpreted by the media to mean that Ireland should be flexible on the issue of tax, including Corporation Tax, as it tries to stabilise the public finances. For this reason, the Department of Finance issued a press statement on October 1st confirming that the 12 ½% rate was a cornerstone of Irish Government policy and would not change. This press statement was also disseminated to business groups. Updated briefing on Ireland's corporation tax regime has also since been circulated to all Irish embassies.

5. Since the 1950s Ireland has used its corporate tax strategy to encourage the growth of domestic business and attract foreign direct investment. The list of factors that influence investment decisions and profitability is well known (for example, well-educated workforce, English speaking population and access to

the European market). While all are important factors, the tax rate remains the key policy tool given the weakness of other factors due to Ireland's loss of competitiveness in the boom years and the fiscal constraints imposed by the recession.

6. In line with a Government Decision of May 1997, the standard rate of Corporation Tax was reduced on a gradual basis from 38% in 1997 to a rate of 12.5% on trading profits from 1 January 2003. Passive income and income from certain 'excepted' trades (e.g. mining, petroleum activities and trading in development land) are taxed at a higher rate of 25% as are company Capital Gains.

7. Our single 12.5% rate on trading profits has over the years become akin to a brand name associated with Ireland; its single rate simplicity is part of the attraction which IDA and others market abroad.

8. The importance of the 12.5% rate was recognised by the present Government in *An Agreed Programme for Government 2007- 2012*: "We recognise the vital role played by low taxes in our economic success. We guarantee that the 12.5% rate of corporation tax will remain". This Programme also stated that the Government would "Keep Ireland's Corporation Tax at its current level at most and veto any EU proposal which might undermine this".

9. The *Renewed Programme for Government* published in October 2009 echoed the sentiments of the earlier Programme: "We recognise the vital role played by low taxes in our economic success. We guarantee that the 12.5% rate of corporation tax will remain".

10. The Minister for Finance has consistently highlighted the importance of the single low rate and that it would remain unchanged. The Budget 2009 speech stressed that "the 12.5% rate was an important element in our taxation system and a cornerstone of our industrial development in the last decade", while also highlighting that "the rate is not for changing upwards and that it will continue to be a central part of Ireland's economic brand". In his latest Budget 2010 Speech in December 2009, the Minister stated that "the 12.5% Corporation Tax rate will not change. It is here to stay."

11. Recent research by the OECD also points to the importance of low corporate tax rates to encourage growth.[1] In ranking taxes by their impact on economic growth, corporate tax was found to be most harmful. In other words, governments seeking additional tax revenues would be advised to consider increasing all other types of tax (property, consumption and income) before increasing corporate taxes.

12. Ireland's low corporate tax rate does not discriminate based on company size or ownership. It features a low tax rate applied to a broad base. For these reasons, despite the low rate, corporate tax revenue in Ireland is similar to other EU

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[1] *Tax and Economic Growth,* OECD Economics Department Working Paper, 2008.

countries. Corporate tax revenue in Ireland in 2008 was equal to 2.9% of GDP, the average for the EU as a whole was 2.7%.[2]

13. Over a thousand manufacturing companies will experience a significant increase in their CT rate from 10% to 12.5% from next year as the manufacturing rate of CT ends this year. Suggestions have been made that, in current circumstances, we should seek to differentiate between different sectors of the economy in terms of the application of the 12.5% rate (e.g. apply a higher rate of CT to the trading profits of the financial sector). While it may be attractive to theorise about the additional revenues that might accrue by seeking to make a distinction between trading sectors for the purpose of applying the 12.5% rate, the fact is that it would not be feasible to apply a higher tax rate to the trading profits of a sector as large and important as financial services while continuing the pretence of having a single corporation tax rate of 12.5% for trading profits, generally. Such an approach would also call into question the general measure status of our 12.5% rate from an EU State-aid perspective and would likely run counter to the EU Code of Conduct on Tax Competition.

14. A higher corporate tax rate on trading profits may raise some more revenue from certain activities but it would also reduce the incentives for multi-national companies, in particular, and could thus be self-defeating. Capital tends to be very mobile and Ireland is an open economy with a heavy concentration of foreign investment in the corporate sector. Higher corporate tax rates would change company behaviour by disincentivising activity in Ireland and with such an open economy it is relatively easy for this change in behaviour to translate into a smaller tax base.

15. Given Ireland's strong and long-standing commitment to the 12.5% rate, any movement away from this rate would have a significant signalling effect on investment. Certainty is a key element desired by investors and to abandon the commitment to the 12.5% rate would be seen as a major change in policy and result in increased uncertainty about the future direction of the Irish economy and its attractiveness to foreign investment.

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[2] *Taxation Trends in the European Union*, 2010 Edition, Eurostat.

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Recent developments in the broad Corporation Tax regime and the scope for further change

17. There have been significant developments in the CT regime in recent years the purpose of which has been to encourage certain types of activity in the economy and to protect the longer-term interests of the CT regime. These developments include:
    - the introduction of an R&D tax credit in 2004 and subsequent enhancements over the years;
    - a scheme of tax relief for the provision of intangible assets introduced in 2009;
    - a tax exemption scheme for new start-up companies commencing to trade in 2009 and 2010;
    - a scheme of accelerated capital allowances for companies for the purchase of specified energy-efficient equipment; and
    - the introduction of transfer pricing legislation.

R&D tax credit scheme

18. Budget and Finance Act 2004 introduced a 20% tax credit for companies on qualifying additional or incremental expenditure on research and development (R&D) as compared with R&D expenditure in a base year (2003). The tax credit was originally available for set-off against a company's CT liability in the current year with the unused balance available for carry-forward against future years' tax liability until the credit(s) are fully utilised.

19. The R&D tax credit scheme has been enhanced in most Budgets and Finance Acts since its introduction. A recent independent study by Mazars of the cost of global R&D initiatives after tax and other cost incentives has placed Ireland among the world's most competitive locations in this regard.

20. The most significant changes to the scheme have involved
    - Increasing the rate of tax credit from 20% to 25% of incremental R&D expenditure.
    - Permanently setting 2003 as the base-year under the scheme
    - Allowing the carry-back of unused tax credits for set-off against a company's prior year CT liabilities thus generating a tax refund;
    - Providing an option, where there is insufficient current or prior year CT liabilities, for a company to claim unused tax credits in cash over 3 years from the Revenue Commissioners; and
    - Amending the scheme to allow a proportion of capital expenditure on buildings used for R&D purposes to qualify for a tax credit of 25%

(previously expenditure on new or refurbished buildings would only qualify for the tax credit if used "wholly and exclusively" for R&D).

21. There have been ongoing calls for the scheme to move from an incremental to a volume basis under which all R&D expenditure (including levels of expenditure incurred before the introduction of the scheme) would be rewarded with the tax credit. The deadweight cost of such a move would be considerable and would not be justifiable in current circumstances.

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Tax relief for acquisition of intangible assets

23. A scheme of tax relief for the acquisition of specified intangible assets was announced in the 2009 Supplementary Budget and introduced in Finance Act 2009. This measure was introduced to support the development of the knowledge economy and the provision of high quality employment. It was highlighted in the Government's economic recovery plan as a way to fill a gap in our supports for the smart economy and it complements other Government initiatives to promote Ireland as a location of choice for investment in R&D and innovation.

24. The scheme provides for the availability of capital allowances on a flexible basis for capital expenditure on a broad range of specified intangible assets used for the purpose of a trade, including non-depreciating assets such as brands.

25. A number of amendments to the scheme were made in Finance Act 2010 on foot, among other reasons, of the recommendations of the Innovation Taskforce Report:
    - The period in which a specified intangible asset must be used in the trade to avoid a clawback of allowances was reduced from 15 years to 10 years.
    - The list of specified intangible assets covered by the scheme was augmented by the inclusion of applications for the grant or registration of patents, copyright etc. and a broader definition of "know-how".
    - Relief will now be available for capital expenditure incurred prior to the commencement of a trade on the provision of specified intangible assets for the purposes of the trade.

26. The scheme will be reviewed in the context of the 2011 Finance Bill with a view to further possible enhancements, including an examination (based on discussions with industry interests) of whether the definition of specified intangible assets can be amended to facilitate the management or development of environment-friendly (or "green") technologies.

Tax exemption for new start-up companies

27. Budget 2009 and Finance (No. 2) Act 2008 introduced a measure providing that a new start-up company commencing to trade in 2009 will be exempt from Corporation Tax, including tax on capital gains, in each of its first three years to the extent that the tax liability of the company does not exceed €40,000 in those years.

28. The following are the main provisions of the scheme as introduced :
    - The exemption applies to companies incorporated on, and from, 14th October 2008 that commence to carry on a new trade in 2009.
    - The exemption period is three years from the date of commencement of the new trade.
    - Exemption is granted in respect of the profits of a new trade and chargeable gains on the disposal of any assets used for the purposes of a trade.
    - Exemption is granted by reducing the corporation tax relating to the trade and chargeable gains of the company to nil.
    - Full relief applies where the total corporation tax liability does not exceed €40,000 in any of the years of the three year period. Marginal relief will apply between €40,000 and €60,000 to ensure new start-up companies with a liability of just over €40,000 do not have to pay the full amount.
    - A company taking over an existing trade or part of a trade, which was carried out in the State by another person, will not qualify in respect of income of the trade taken over.

29. Finance Act 2010 extended the scheme to companies that commenced to trade in 2010. The further extension of the scheme to companies commencing to trade next year will be considered as part of the Budget/Finance Bill 2011 process.

Accelerated capital allowances for energy-efficient equipment

30. Budget and Finance Act 2008 introduced a new scheme of accelerated capital allowances for expenditure by companies on certain energy efficient equipment in the following three technology categories: Motors and Drives; Lighting and Lighting Controls; and Building Energy Management Systems. The scheme was commenced in October 2008 and companies can claim 100% capital allowances on expenditure on specified eligible equipment in the year of purchase.

31. The scheme was extended to seven categories of technology in Finance (No. 2) Act 2008 to include:
    - Information and Communications Technology
    - Heating and Electricity Provision
    - Process and Heating, Ventilation and Air-Conditioning (HVAC) Control Systems
    - Electric and Alternative Fuel Vehicles

    Finance Act 2010 provided a further extension to include three new categories:

- Refrigeration and Cooling Systems
- Electro-mechanical Systems
- Catering and hospitality equipment

There are now ten categories of technology eligible under the scheme.

32. Expenditure must be above a certain minimum amount in order to qualify for the accelerated allowances. The energy-saving criteria to be met by each category of technology and the list of specified qualifying equipment are developed and maintained by the Sustainable Energy Authority of Ireland (SEAI). The updated criteria and list are published periodically by order of the Minister for Communications, Energy and Natural Resources.

33. The scheme has been established to operate for a trial period of three years (to October 2011). It is understood that the SEAI have conducted a survey on the uptake of the scheme to establish whether it has been successful in encouraging investment by companies in equipment meeting the energy-saving criteria required under the scheme. The results and analysis of this survey together with the results of a cost benefit analysis of the scheme carried out by the Preferred Policy Measures Group will be examined as part of a review of the scheme to be carried out by this Department in conjunction with the Department of Communications, Energy and Natural Resources in the context of Finance Bill 2011.

Transfer Pricing legislation

34. Finance Act 2010 introduced legislation setting out transfer pricing rules that apply the arm's length principle to trading transactions between associated persons.

35. As well as protecting the Irish tax base and removing the uncertainty regarding the application of internationally accepted transfer pricing standards in Ireland, this legislation aligns Ireland with best international practice, by formally adopting the OECD Transfer Pricing Guidelines, and enhances Ireland's capacity to influence the direction of future developments in relation to transfer pricing in international taxation. It will also position the Revenue Commissioners better in intervening on behalf of companies where other jurisdictions adopt transfer pricing positions that do not accord with the arm's length principle.

36. Given the increased emphasis on transfer pricing at this time and the cessation of the transfer pricing provisions in the manufacturing legislation with the ending of manufacturing relief this year, it was appropriate to codify and clarify our existing law and practice in these new provisions and that is the reason for the introduction of this general legislation now.

37. The Tax Strategy Group may wish to discuss the issues raised in this paper.

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