Budget 2006:

Review of Tax Schemes

Volume III:

Internal Review of Certain Tax Schemes

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Introductory Note

A major review of various existing tax incentive schemes was undertaken in 2005, on foot of the announcement by the Minister for Finance, Mr Brian Cowen T.D., to this effect in Budget 2005.

The review process involved internal reviews conducted by officials in the Department of Finance and the Office of the Revenue Commissioners, as well as reviews of certain schemes by external consultants.

The finalised reports of the internal reviews are set out in this volume, which is Volume III of the series. The review of certain sectoral property-based tax incentive schemes, conducted by Indecon, is set out in Volume I. Volume II reproduces the review of area-based tax incentive renewal schemes, conducted by Goodbody Economic Consultants.

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INTERNAL REVIEW OF CERTAIN TAX SCHEMES

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INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section A: Tax Relief for Profits or Gains from Commercially-Managed Woodlands

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Chapter 1 - Executive Summary

Purpose of Study

The twin aims of this review were to establish the objective of the current scheme of tax relief for gains arising from the occupation of woodlands on a commercial basis and to determine if the operation of the scheme resulted in an overall net cost or benefit to the economy.

Nature of the Relief.

Section 232 of the Taxes Consolidation Act, 1997, exempts profits from the occupation of woodlands managed on a commercial basis from both income and corporation tax and Section 140 of the same act exempts distributions, to the extent that they are made from such profits, from assessment to tax in the hands of the recipient. In addition, there are also special provisions for forestry with regard to Capital Gains Tax, Capital Acquisitions Tax, Value Added Tax and Stamp Duty.

The Revenue Commissioners Statement of practice (SP IT/1/90, July 1990), exempts premium payments made to landowners under EU forest premium scheme and Revenue precedents extended the relief to cover profits from growing Christmas trees. An amendment in 1979 closed off a loophole whereby losses incurred in woodland activity could be written off against all other income while an amendment in 2003 imposed a reporting requirement on those claiming the relief in relation to income and corporation tax.

Description of Study

The review focused on the five year period 2000 to 2004 and estimated the cost of the relief in terms of tax foregone and tax administration and the benefits associated with the output of timber for this period. These estimates were then combined to determine if the tax concessions generated an overall cost or benefit for the economy. Sensitivity analysis was carried out on the estimates to see how robust they were.

Estimates of the costs associated with the relief were bases mainly on information provided by the Forestry Service and The Revenue Commissioners while the estimates of the benefits were based mainly on three Irish recent studies on forestry: two by Dr. P. Bacon - “Forestry: A Growth Industry in Ireland” (2003) and “A Review and Appraisal of Ireland’s Forestry Development Strategy” (2004) and P. Clinch’s “Economics of Irish Forestry” (1999).

Principal Findings

The study found that while it was not possible to identify any specific aim or objective for the granting of the relief other than as a support for government forestry policy in general, it was possible to show that there was a net economic cost to society from the operation of the relief over the period. The total cost to the State in terms of tax foregone and tax administration costs was estimated to be €43.5 million or €8.7 million p.a. and that the net economic benefit after deducting deadweight of 98.4% was estimated to be of €18.6 million or €3.7 million p.a. Combining these figures resulted in costs exceeding benefits by €24.9 million for the period, or by €5 million p.a.

However, even using conservative assumptions regarding the value of benefits and a very high level for deadweight the outcome was very finely balanced. Both the costs and benefits can be expected to increase in the future but as the percentage of output coming from the private sector increases it is likely that the level of deadweight will decline and result in the generation of overall positive economic benefits.

It can also be expected that any attempt to tax forestry receipts, particularly premium payments could lead to a significant reduction in the level of afforestation. Current Government forestry policy calls for continued afforestation of 20,000 hectares p.a. up to 2035. However, given that Coillte have now effectively stopped all new planting the attainment of these targets depends almost totally on the private sector. Any action which makes investment in forestry less attractive (such as the removal of the existing tax concessions) could make the attainment of this target even more difficult if not impossible and could undermine current Government forestry policy. For these reasons the study concludes the relief in its present form should be maintained going forward.

Glossary of Terms

AMR – Average Marginal Rate

CAP – Common Agriculture Policy
CAT - Capital Acquisitions Tax
CGT - Capital Gains Tax
CIP – Census of Industrial Production
CO_2 – Carbon Dioxide
COFORD – National Council for Forestry Research and Development
CSO – Central Statistics Office
CVM – Contingent Valuation Model

EC – European Commission
ESRI – Economic and Social Research Institute
EU – European Union

ha - hectare

IForUT – Irish Forestry unit Trust
ITC - Irish Timber Council

m^3 – cubic metres
Mt – Metric Tonne

NACE – General Industrial Classification of Economic Activity within the European Communities

p.a. – per annum

REPS – Rural Environmental Protection Scheme
ROS – Revenue Online Service

TCA – Taxes Consolidation Act

VAT – Value Added Tax

WTP – Willingness to Pay

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Chapter 2 – Objective of the Relief

The purpose of this chapter is to outline the objective or purpose of the woodland relief which was first introduced in the 1969 Finance Act. However, before addressing this issue, a brief description of the current taxation position in relation to woodlands/forestry is provided[1].

2.1 Current Taxation Position

Income and Corporation Tax: Section 232 of the Taxes Consolidation Act, 1997 is the principal legislation governing woodland relief. The section exempts from both income and corporation tax, *gains from the occupation of woodlands managed on a commercial basis and with a view to the realisation of profits*. Section 140 of the same act, in turn exempts distributions, to the extent that they are made from such profits, from assessment to tax in the hands of the recipient.

The exemption was introduced by Section 18 of the Finance Act, 1969 and originally applied only to income tax. Subsequent legislation has extended the relief to a wider number of taxes[2]. Revenue precedents have decided that this exemption extends to cover profits form the planting and harvesting of Christmas trees but not to the sale of foliage from holly bushes. The only restriction of the relief was an amendment in 1979 which closed off a loophole whereby losses incurred in woodland activity could be written off against all other income while an amendment in 2003 imposed a reporting requirement on those claiming the relief in relation to income and corporation tax. Prior to the 2003 amendment there was no requirement on such taxpayers to disclose details of any gains from the occupation of woodlands on which they were claiming the relief.

In addition to the granting of relief for gains arising from the occupation of woodland managed on a commercial basis a Revenue Commissioners Statement of practice (SP IT/1/90, July 1990), extended the exemption offered by Section 232 to cover premium payments made to landowners under the EU forest premium scheme.

Capital Gains Tax: Individuals (not companies) are exempted from capital gains tax on the sale of standing timber and saleable underwood.

Capital Acquisitions Tax: The valuation of commercial woodlands is relieved for CAT on the same basis as agricultural land.

Stamp Duty: Growing timber in commercial woodlands is exempt from Stamp Duty but the underlying land is not.

Value Added Tax: Commercial forestry operations are regarded as agricultural production and are exempt from VAT but the exemption can be waived (e.g. in the case of VAT registration for the purposes of reclaiming VAT on inputs).

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[1] See Appendix I for more general detail on forestry in Ireland
[2] See Appendix II for more detail on the position prior to 1969 and the subsequent extensions of the relief.

2.2 Objective of the Relief

In relation to the introduction of tax relief for forestry in 1969 and its subsequent extension, Dáil Debates and other records do not identify any specific aim or objective for the granting of tax relief to the sector other than supporting government forestry policy[3] which has as its overall aim,

"the development of forestry to a scale and in a manner which maximises its contribution to national economic and social well-being on a sustainable basis"[4].

Speaking in the Seanad on the committee stage of the Farm Tax Bill 1985 the then Minister for the Environment, Mr. Kavanagh said that:

"As far as the exemption of commercial woodlands is concerned, timber is an investment which involves a long pay-back period. It is a vital national resource and was recognised as a big area for development in the Government White Paper on Industrial Policy. It is right and proper that it should be encouraged through taxation measures[5]".

Taxation is one of a number of economic instruments which can be used by Government to encourage markets to act in ways that achieve desired policy objectives and Irish Governments over the years have attempted to make forestry more attractive not only by giving tax exemptions on profits from the occupation of woodland but also by offering afforestation grants and forest premium payments. Economic theory tells us that such Government intervention/support for any sector should be based on the necessity to address a clearly identified market failure. In the case of forestry, a paper on Taxation and Forestry prepared for the Forestry Commission Wales[6] identified three such market failures as:

- The Existence of Externalities
- The Existence of Public goods and
- Limited access to resources.

Externalities both positive and negative occur when actions by a firm or individual create benefits (or costs) that do not accrue to that firm or individual, e.g. forestry activities provides benefits such as landscape, wildlife and recreation which benefit the tourism industry.

Public goods are goods that may be under-provided by markets because they are 'non-excludable'[7] and/or 'non-rivalrous'[8] even though their provision adds to everyone's wellbeing. Provision of these goods may be subject to the free-rider problem whereby it is not possible to exclude other people from consuming a good that someone else

[3] For a note on the evolution of Government forestry policy see Appendix III
[4] The Strategic Plan for the Development of the Forestry Industry in Ireland – "Growing for the Future" -Dept of Agriculture, Food and Forestry – 1996
[5] Seanad Debates – Volume 108 – 17 July, 1985
[6] P. Snowden (2003)
[7] Non-excludability means that it is not possible to provide a good or service to one person without it being available for others to enjoy
[8] Non-rivalry means that consumption of a good by one person does not prevent others from enjoying it

has bought. The supply of public goods can be ensured by compelling everyone to pay for them through the tax system or adapting the tax system to encourage the supply of these goods.

Limited access to resources covers such items as capital, training, research and development etc. Sometimes individuals and/or firms cannot obtain access to capital to invest in beneficial activities, e.g. afforestation, due to issues such as the long period of the investment which is exacerbated by the existence of high entry and exit costs in the industry and the very restricted flexibility to react to market changes. The cost of paying for such resources could be offset by minimising or eliminating tax liabilities.

Carbon Sequestration Benefits of Forestry

In relation to externalities arising from forestry, Bacon (2003)[9], pointed out that these have traditionally, been considered as the leisure and amenity facilities forests offer and the creation of greater biodiversity but that attention has increasingly turned to the carbon sequestration role of forests where the greatest potential value arises. Carbon sequestration is the term used to describe the ability of trees to absorb carbon from the atmosphere in the form of carbon dioxide (CO_2) and store it as timber where it remains until the wood or products made from the wood decay. This positive externality associated with forestry has assumed greater significance following the Kyoto agreement and the adoption of *Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC*. This Directive created a legal basis under which penalties for excess emissions as defined by the agreed Kyoto limits will be levied and presents Member States with legally enforceable obligations and agreed fixed penalties for excess emissions. These have been set at €40/tonne in the period 1/1/2005 to 31/12/2007 and at €100/tonne thereafter. The economic value of CO_2 that is removed from the atmosphere or avoided through lower emissions will be the value of the penalties that will be levied for exceeding the target emissions of CO_2.

Under Kyoto, Ireland is committed to limit the growth in emissions of greenhouse gases to 13% above its 1990 output. However, unless there are major changes made it is assumed that Ireland will not be able to meet its Kyoto commitments. Based on recent trends, the National Climate Change Strategy has estimated that by the year 2010, Ireland's net emissions of all greenhouse gas, calculated in accordance with the Kyoto Protocol, will be between 33.8% and 37.3% above those in 1990 while emissions of CO_2 would be 62.7% above the base year.

This estimate implies that Ireland would need to achieve annual emissions savings between 11.154 to 13.054 Mt CO_2 equivalent p.a. in the period 2008 – 2012 to stay within the 13% growth limit, i.e. net emissions of 60.74 Mt CO_2. Bacon (2003)[10] calculates that under the projections contained in the *National Climate Change Strategy* the value of the excess emissions would be in the range €1,100 to €1,300 million in 2010. Given the ability of forests to capture and store atmospheric CO_2 the

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[9] Dr. P. Bacon - "Forestry: A Growth Industry in Ireland" (2003)
[10] Dr. P. Bacon - "Forestry: A Growth Industry in Ireland" (2003)

beneficial impact on net CO_2 emissions of any increase in the level of forest cover will have an economic value.

2.2 Conclusion

Therefore, while there may not have been any specific objective stated at the time the relief was introduced other than supporting forestry policy generally, the existence of a number of market failures in the forestry sector and especially the positive externality associated with carbon sequestration provide new objectives and justifications for continued Government support for forestry.

Chapter 3 - Costs of Tax Exemption

In this chapter the total cost to the State in terms of tax foregone from the operation of the woodland tax exemptions for the five year period 2000 to 2004 is estimated. The estimates of costs arrived at will then be compared with estimates of the market and non-market benefits associated with forestry to determine if the tax concessions generate an overall cost or benefit for the economy. Other costs incurred by the State in relation to forestry such as grant and premium payments to growers (part-funded by the EU), the cost of running the forestry service and the provision of advice through Teagasc etc. are not included. These costs amounted to just over €500 million for the period – or over €100 million p.a.[11].

3.1 Summary of Costs

Details of the total cost to the State from the operation of the tax exemptions on gains from *woodlands managed on a commercial basis* for the period 2000 - 2004 in terms of tax foregone and administrative costs are set out below in Table 3.1. From this table it can be seen that total costs were estimated to be €43.5 million or €8.7 million p.a.

Table 3.1: Tax Costs of Woodland Relief

	2000	**2001**	**2002**	**2003**	**2004**	**Total**	**Average**
Tax Foregone	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**
Income Tax							
Receipts from Sale of Timber	119	199	400	474	1,241	2,433	487
Annual Premium Income							
Farmers	1,221	1,841	2,108	2,160	2,386	9,716	1,943
Non-Farmers	1,327	1,401	1,468	1,528	1,605	7,329	1,466
Corporation Tax	5,133	2,948	2,169	2,626	1,836	14,712	2,942
Stamp Duty	72	237	356	773	493	1,931	386
Capital Acquisitions Tax	425	425	425	425	425	2,125	425
Capital Gains Tax	246	820	1,199	1,804	1,201	5,270	1,054
V.A.T.	0	0	0	0	0	0	0
Tax Administration	0	0	0	0	0	0	0
Total	8,544	7,871	8,125	9,789	9,187	43,516	8,703

Income-tax foregone on the annual premium payments received by growers at €17 million emerged as the largest source of lost revenue followed by corporation tax foregone at €14.7 million with smaller amounts of CAT, CGT and Stamp Duty foregone. Between them, the two highest cost headings accounted for over 70% of the

[11] Revised Estimates Volume (REV) 2001, 2002, 2003, 2004 & 2005.

total costs of the relief while tax administration and V.A.T. do not appear to give rise to any costs. It is understood from the Revenue Commissioners that in relation to the use by the top 400 earners of this relief in a major way to minimize their tax liabilities that the latest returns of income analysed (i.e. 2001 and 2002) do not capture this information.

3.2 Details of Estimates of Tax Foregone By Tax Head

While Table 3.1 provided a summary of the costs of the relief, the following sections will outline how these estimates were derived for each heading.

3.2.1: Income/Corporation Tax Forgone

Income from the commercial operation of woodlands for individuals and corporate bodies arises from two sources;

- receipts from the sale of timber and
- annual premium income.

Income from the sale of timber is, in turn, comprised of revenue from thinning activity[12] undertaken during the rotation of the tree crop and the sale of the clear felled trees at the end.
In the case of Income and Corporation Tax on woodland gains, no requirement was placed on the taxpayer in the Finance Act 1969 which introduced the relief to report the amount of income exempted. However, Section 35(1)(b) of Finance Act 2003 has imposed a requirement on those taxpayers, availing of relief under Section 232 of the TCA 1997, to include in their returns of income any profits or losses incurred in any chargeable period commencing on or after 1 January 2004. No such returns were due to be received before the compilation of this report although they will be available going forward. In the absence of details of profits and losses exempted under these tax heads the totals of tax foregone for the periods under examination have had to be estimated.

3.2.2: Income Tax Foregone from the Sale of Timber by the Private Sector

Tax foregone from the sale of timber by the private sector was estimated to amount to €119k for 2000 rising to €1.24 million in 2004 based on approximations of the output of timber from the private sector. The output of timber in Ireland is currently dominated by one state owned producer responsible for c.95% of output. The remaining 5% is supplied by a small number of corporate bodies and around 20,000 individuals, 84% of who are classified as farmers[13].

There is currently no formal reporting procedure for the volume or value of private sector sales and while the Forestry Service has been requested to introduce obligatory reporting of actual sales volume as part of their Felling License issuing procedures, to date there has been reluctance to place this administrative burden on forest owners. In

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[12] Thinning is regarded as a necessary maintenance operation in order to maximise the potential of the final timber crop and is usually carried out at five year intervals starting in year 20 of a 40 year cycle. First and indeed second thinning in general terms can be regarded as a break-even operation. Returns are at best marginal and not very attractive for the individual owner. While a small positive revenue flow may be expected from subsequent thinning, the main revenue from the sale of timber can be expected to arise when the trees are clear felled.
[13] Source: Forestry Service

the absence of official data on private sector output the only quasi-reliable source of information on the volume of output of the private sector is the Irish Timber Council (ITC) which represents the main sawmills in Ireland and process c.95% of all the available sawlog material[14]. As other smaller sawmills that are not members of ITC also purchase some material from the private sector, COFORD have estimated that the volumes supplied to ITC mills could be increased by between 10-20%. The ITC output totals were therefore increased by 15% (the mid point between these two estimates) to give an estimate of total private sector.

However, private sector output is in turn currently dominated by one producer - the Irish Forestry Unit Trust (IForUT). As their income is exempt on the basis of their status as a Revenue approved pension trust, they do not avail of Section 232. For this reason their output has been deducted from total private output before estimating the amount of tax foregone but other smaller forestry investment vehicles do avail of the tax concession and are included.

Table 3.2: Details of Private Sector Output by Volume: 2000 - 2004

	Private Output to ITC Mills	Total Private Output	IForUT Output	Non-IForUT Private Output
	m^3	m^3	m^3	m^3
2000	72,000	82,800	66,000	16,800
2001	73,000	83,950	55,000	28,950
2002	110,000	126,500	68,000	58,500
2003	180,000	207,000	155,000	52,000
2004	200,000	230,000	80,000	150,000

Sources: COFORD, ITC, Irish Forestry Unit Trust

While the information in Table 3.2 above provides an estimate of the quantity of private sector output a further assumption must be made in relation to the quality of the timber supplied by the private sector before calculating total revenue received by the private sector. Figures compiled by Coillte give details of the average price per cubic meter of standing timber of all sizes for the period 2000 – 2004. These range from a low of €5.50 per m^3 for the smallest sized timber in 2004 to a high of 53.25 per m^3 for the largest sized in 2000. If it is assumed that the output of the private sector is equally distributed across the various sizes and grades of timber then the average price for each year can used to estimate the gross revenues received by the private sector. Allowing for selling costs of €4.5 per m^3 [15] would produce estimated net revenue of €398k in 2000 rising to €4.1 million in 2004 (assuming no other allowable costs).

[14] Irish Timber Growers Association

[15] COFORD

Table 3.3: Details of Private Sector Tax Foregone: 2000 - 2004				
	Non-IForUT Private Output	**Average Price of Standing Timber3**	**Estimated Net Revenue**	**Tax Forgone at 30% Average Tax**
	m^3	**€**	**€'000**	**€'000**
2000	16,800	28.18	398	119
2001	28,950	27.43	664	199
2002	58,500	27.28	1,333	400
2003	52,000	34.87	1,579	474
2004	150,000	32.07	4,136	1,241

Sources: COFORD, ITC, Irish Forestry Unit Trust and Coillte

It is not possible at present to apportion the private sector output between those assessable to income tax and those assessable to corporation tax, nor is it possible to ascertain what percentage of those assessable to income tax would be liable to tax even if income from their woodland was added to their total income. However, given that large scale corporate involvement in private planting did not emerge until the mid-eighties, the forestry planted at that time will only come due for thinning from around 2015. For this reason the level of output from the corporate sector for the period 2000 – 2004 can be expected to be negligible with most of the output arising from the non-corporate plantations planted earlier. If it is therefore assumed that **all** the private sector output came from those liable to income tax and that they all had an average income tax liability of 30% (the annual average marginal rate for income taxpayers applied by the Revenue Commissioners) then the estimated tax foregone would amount to €119k for 2000 rising to €1.24 million in 2004

However these estimates may be an overstatement because some of the output may be produced by those liable to tax at a lower (or zero) rate and some small portion may be produced by those liable to corporate tax. In addition, while the assumption of no other allowable costs is reasonable, given that the prices quoted are for standing timber (i.e. prior to harvesting and transportation) and various grants are available for planting and maintenance costs, the assumption that the output of the private sector is equally distributed across the various sizes and grades of timber may not reflect reality. It is possible that a large portion of the private sector output is of the lower grades of timber. If this is the case then the estimate of net revenue will be overstated.

3.2.3: Income Tax Foregone on Annual Premium Income

Total income tax foregone due to the exemption of premium payments was estimated at €2.5 million in 2000 rising to €17 million in 2004. As outlined above income from woodlands arises from two sources – timber sales and premium income and the previous section derived an estimate for the income tax foregone from private sector timber sales. After a brief section outlining details the payments of premium income for the period 2000 -2004, the following two sections will describe how estimate tax foregone on premium income was derived, firstly for farmers and then for non-farmers. The reason for this division is because farmers are treated differently under the premium scheme receiving higher payments per hectare than non-farmers.

Details of Premium Income Paid

In 2004 premium payments were made to a total of 19,676 individual timber growers - private and corporate up form 14,632 in 2000. During the same period the total grant aided planted area rose from 132,074 ha to 180,542 ha.

Table 3.4: Details of Premium Payments; 2000-2004				
	Total Premium Paid	**Area Covered**	**Average Premium**	**Number of Recipients**
	€m	**Hectares**	**€m per ha**	
2000	29.7	132,074	225	14,632
2001	42.5	147,221	289	16,038
2002	48.1	161,956	297	17,545
2003	49.3	170,925	288	18,556
2004	54.1	180,542	300	19,676

Source: The Forestry Service

The average premium payment was €225 per ha in 2000 rising to €300 per ha in 2004. As the average grant assisted area for each claimant was just over 9 ha, the average annual payment per claimant in 2000 was €2,030 rising to €2,750 by 2004. However, nearly 70% (or 13,874) of recipients had planted areas less than this and c.90% (or 17,628) of recipients had planted areas under 20 ha. Between 1990 and 2004 only 45 applicants applied for grants on plantation exceeding 100 ha. Farmers accounted for the bulk of those in receipt of premium income with 11,951 out of 14,632 claimants in 2000 (or 82%), and 16,460 out of 19,676 (or 84%) by 2004. The remaining 16% (or 3216 claimants) in 2004 made claims in respect of 31,464 ha.

Tax Foregone on Premiums Paid to Farmers

It is not possible at present to determine what percentage of farmers in receipt of forestry premium payments (if any) would be liable to tax and if liable to tax at what rate. However, if it assumed that those farmers in receipt of forestry premium payments who are liable to tax;

a) pay the same average tax rate as other farmers who are liable to tax,
b) have the same average level of afforestation as other farmers in receipt of premium payments who are not liable to tax,
c) That the same percentage of farmers with forestry pay tax as those without and
d) that non-farmers receive an average premium payment of €173.95[16] per ha,

(i.e. that on average they are similar to other farmers) an estimate can be made of the amount of tax forgone on the premium payments by applying an average tax rate for the farming sector to an estimate of the amount of the total premium payments received by farmers.

[16] Non-farmers receive reduced premium payments of €171 per ha for coniferous plantations and €181 for broadleaf planting. Those in receipt of grants and premium payments are required to plant a minimum of 20% broadleaves. If an average 80/20 split is assumed for all non-farmers the average premium payment is €173.95

Average Tax Rate for the Farming Sector

Information on the taxation of farmers complied by the Revenue Commissioners[17] show that there were an estimated 37,300 farmers (or 37.75%) liable to pay tax on farm profits. These figures exclude 10,600 "trader" farmers of whom an estimated 5,700 were liable to tax as it is not possible to distinguish the number of these who pay tax on farm profits only. The gross income of those full time farmers assessable to tax was €1,625 million. However, a percentage of this income (c.39% in 2002) is liable to taxation as PAYE income. Appling this percentage to the gross income of those full time farmers liable to tax (i.e. €1,625 million) gives the gross income from farming as €991 million. As the total yield from farmers in respect of income tax on farming profits for 2002 was €126.2 million this gives an average tax rate for farmers of c.13%.

Estimate of Total Premium Payments received by Farmers

From the table below we can that the premium received by farmers was just under €25 million in 2000 and increased to just over €48 million in 2004. These totals for the premium received by farmers were compiled by deducting an estimate of the premium payments to non-farmers from total premium payments made each year. The non-farmer premium total was estimated by multiplying the area on which they were claiming payments by an average payment of €173.95 per ha assumed above.

Table 3.5: Premium payments received by Farmers

	Total Premium	Non-Farmer Area	Non-Farmer Premium*	Farmer Premium
	€m	Hectares	€m	€m
2000	29.7	27,665	4.81	24.89
2001	42.5	28,674	4.99	37.51
2002	48.1	29,595	5.15	42.95
2003	49.3	30,413	5.29	44.01
2004	54.1	31,464	5.47	48.63

Source: Forestry Service, *Assuming average premium of €173.95 per ha

Applying the average tax rate calculated above to the estimated premium income received by farmers gives a tax foregone total of €1.2 million in 2000 rising to €2.4 million in 2004

However, it appears that forestry farmers may not be representative of farmers as a whole, being more likely to have larger farms with larger farm enterprises. A 2002 COFORD survey[18] found that "farm forestry was most likely on larger farms (50 ha +) with larger enterprises, especially dairying (77% having more than 35 dairy cows, 40% having more than 70 cattle and 50% having more than 100 ewes)". It may be that a higher percentage of farmers with forestry would be liable to tax and if this is the case the amount of the tax foregone may be somewhat understated. However, given the low average rate of tax estimated for the sector the percentage of farmers liable to tax would have to change by a large amount to significantly affect the results.

[17] Latest data available applied to the 2002 tax year.

[18] Factors Influencing Farmer Participation in Forestry, COFORD (2002)

Tax Foregone on Premiums Paid to Non-Farmers
The premium income estimated for non-farmers above was distributed amongst 3216 claimants who had made claims in respect of 31,464 ha. However, details obtained from the published accounts of the principal corporate bodies and trusts involved in forestry show that they own between 9000 and 10,000 ha of premium aided land. The remaining non-farmers in receipt of premium payments mainly comprise individuals and some small private companies (who do not publish details of their holdings).

It is not possible at this stage to obtain a detailed breakdown of these non-farmer claimants and their existing liability to tax. If it assumed that the large companies and trusts account for 9500 ha on average of the non-farmer area and that **all** the rest of the non-farmer area is held by individual tax payers and **all** of these are liable to pay tax at 42% and then the amount of premium income they would have received would have been €3.1 million in 2000 rising to €3.8 million in 2004 and the tax forgone would have been €1.3 million in 2000 rising to €1.6 million in 2004. This is likely to be an upper limit as some of these premium payments may be received by corporate bodies liable to tax at 12.5%, or by individuals liable to income tax at 20% or by those with no tax liability.

3.2.4: Corporation Tax Foregone
As explained below corporation tax foregone due to the existence of woodland relief was estimated at €5.1 million in 2000 falling to €1.8 million in 2004[19]. This comprises tax foregone on Coillte's profits and an estimate of the tax forgone for other corporates.

Tax Foregone by Coillte
As has already been shown timber production in Ireland is currently dominated by one State owned corporate body – Coillte, which accounts for c.95% of production[20]. Their published accounts already identify the amount of corporation tax foregone that is attributable to woodland relief.

Table 3.6: Tax not paid by Coillte due to Woodland Relief

2000	2001	2002	2003	2004
€ '000	**€ '000**	**€ '000**	**€ '000**	**€ '000**
5,126	2,957	2,193	2,636	1,836

Source: Coillte Annual Accounts

The total tax forgone by the Exchequer was €14.75 million for the period 2000-2004 or an average of €2.95 million p.a. It should be noted that although the profit before taxation rose during the period the amount of tax forgone fell due to the reduction of the rate of corporation tax from 24% in 2000 to 12.5% in 2003.

Tax Foregone due to Companies other than Coillte
To complete the picture of the corporate sector an examination of the published accounts of the larger corporate forestry owners covering the principal firms involved in the business was carried out. These included the accounts of 11 Irish Forestry

[19] This estimate of corporation tax forgone may be overstated because in the absence of the relief, individual companies may have taken alternative measures to reduce their liability. It is not possible to adjust for such potential actions.
[20] Forestry Service

Investment Plans, 6 Irish Forestry Investment Funds, the Millennium Forestry Fund, the Premier Forestry Fund etc. The tax foregone in relation to these companies is outlined below. However, it was not possible to extract profit and loss details for a number of other private companies as they relied on specified exemptions contained in Sections 10 and 12 of the Companies (amendment) Act 1986 to prepare and submitted abridged financial statements on the grounds that the companies were entitled to benefit from these exemptions on the grounds that they were small companies. Given the size of these companies it is unlikely that the inclusion of their results would increase the tax foregone total greatly.

Table 3.7: Tax Foregone in respect of Companies other than Coillte due to Woodland Relief*

2000	2001	2002	2003	2004**
€	€	€	€	€
6,754	-8,583	-24,301	-10,272	34

*Source: Company Annual Returns
** Only a limited number of returns for 2004 lodged to date

The total of tax foregone for the period 2000 to 2004 was -€36,368 representing a saving to the State due to the combined losses of these companies being unrelieved against other income. These firms are relatively newly established, having only became involved in this sector from the mid 1990's onward when grants and premium were extended (albeit at reduced rates) to non-farmers. As a result they receive very little income from woodland but are incurring ongoing expenses (as the initial cost of planting is covered by a grant it is not available for set off). The resulting woodland losses cannot be offset against other income and so go unrelieved. However, over the same period these companies paid over €8 million or €1.6 million p.a. in tax to the exchequer on other gains such as capital gains on the sale of sites and way-leaves and corporation tax on undistributed surpluses etc. As these companies have yet to be involved in major harvesting but it can be expected that corporation tax foregone from this sector will rise after 2015 as thinning revenues come on stream but it is unlikely that any major revenue from clear felling will arise until after 2035.

3.2.5: Stamp Duty Foregone

Figures supplied by the Revenue Commissioners show that stamp duty foregone due to the existence of woodland relief amounted to €72 k for 2000[21] and €0.5 million for 2004 (an average of €464k p.a. if 2000 is excluded).

Table 3.8: Stamp Duty Woodlands Relief

Year	Duty before Relief	Duty After Relief	Tax Forgone	No of Reliefs Granted
	€'000	€'000	€'000	
2000*	79.15	6.76	72.39	6
2001	274.27	37.35	236.92	35
2002	400.72	44.39	356.33	36
2003	1,354.57	581.82	772.75	45
2004	1,220.73	727.64	493.10	54

Source: Revenue Commissioners

[21] Not a full year figure as SDAS data base (from which totals extracted) only commenced live use in May 2000

The general trend in the amount of duty foregone has been upward as the number and value of the transactions increase. It is not possible to project future levels of duty foregone but as the value of the standing timber on land is expected to increase in future years it can be expected that the duty foregone will also increase.

3.2.6: Capital Acquisition Tax (CAT) Foregone

Unlike the case of stamp duty it is currently not possible to work out the level of CAT foregone due to woodlands relief. This is because even though woodland property is treated in the same manner as agricultural property for the purposes of the relief it is not identified or recorded separately.

However, an estimate prepared for the Department of Finance found that the cost in terms of tax foregone due to CAT relief on agricultural property was €15 million in 2003. If it assumed that the ratio of agricultural property to woodland property (by area) availing of the relief is the same as ratio of agricultural land to privately owned woodland in the country as a whole then it is possible to make a very crude estimate of the CAT foregone on woodlands.

The total utilised agricultural area in Ireland is 4.3 million ha and the area of privately owned woodland is c.300,000 ha (or c. 7%). This suggests that the cost in terms of tax foregone would be in the region of €1 million. However, such an approach assumes that the average value per hectare of all property is the same and ignores the value of buildings etc. As the value of forestry land is much less that the value of prime agricultural land and the young age of most private forestry in Ireland means that the value of the standing timber is likely to be low this estimate is likely to overstate the tax foregone. If it is assumed that the average price land for forestry is in the region of 40-45% that of agricultural land [22] then an indicative cost in terms of CAT foregone would be around €425k. If it is further assumed that 2003 was a typical year then this figure gives an indication of the annual amount of CAT foregone.

3.2.7: Capital Gains Tax (CGT) Foregone

CGT foregone due to the existence of woodland relief was estimated at €246 k for 2000[23] and €1.2 million for 2004 (an average of €1.26 million p.a. if 2000 is excluded). As with CAT it is not currently possible to work out the level of CGT foregone due to woodlands relief because claims for exemption from CGT on woodlands are aggregated with many others in a box called "other reliefs" in the CGT form (& forms 11 &12) and while many of these forms are available for analysis (for returns filed through ROS-currently) it is not possible to separately identify how much of these "other reliefs" are due to the woodland exemption.

However, if it is assumed that these availing of the CGT exemption (sellers) broadly mirror those claiming the stamp duty exemption (buyers) the figures supplied by Revenue in relation to stamp duty relief can be used to establish an estimate of CGT foregone. Table 3.9 below shows the value of woodland transactions exempted from stamp duty each year and the theoretical maximum cost of CGT foregone if this value of the woodland was taxed at 20%. This approach probably overstates the cost to some degree as it assumes that the gain for CGT purposes is equal to the

[22] Comparing the average purchase prices paid by the Irish Forestry Investment Plans for forestry land and the CSO's data on the average prices of agricultural land

[23] As this figure depends on Stamp Duty returns 2000 does not contain information for the full year.

consideration exempted from stamp duty (i.e. the base cost at the time of transfer was zero) but this calculation does provides an upper bound on the cost.

Table 3.9:Commercial Woodlands CGT Relief			
Year	No of Reliefs Granted	Value of Woodland exempted from Stamp Duty	Maximum CGT Cost of relief (I.e. * 20%)
-		€'000	€'000
2000*	6	1,229.7	245.9
2001	35	4,098.9	819.8
2002	36	5,992.7	1,198.5
2003	45	9,018.1	1,803.6
2004	54	6,006.1	1,201.2

Source Revenue Commissioners

* Not a full year figure as SDAS data base (from which totals extracted) only commenced live use in May 2000

The general trend in the amount of CGT like that for stamp duty foregone has been upward as the number and value of the transactions increase. Similarly it is not possible to project future levels of tax foregone but as the value of the standing timber on land is expected to increase in future years it can be expected that the tax foregone will also increase.

3.2.8: Value Added Tax (VAT) Foregone

There is no loss of VAT in the normal way from the operation of woodland relief. As VAT is in essence a consumption tax levied on final consumers the fact that the first stage of the forestry supply chain is not subject to VAT should not result in any VAT foregone to the State as the tax on the value added through the production process should ultimately be paid by the final consumer (albeit that some of the tax may be collected at various stages along the supply chain). Where some of the output supplied to processors is utilised directly by these processors (e.g. chippings and waste burned in an on site CHP unit) a small loss of VAT may arise but it is not possible to provide an estimate of such a loss which would be expected to very small in any case.

However, a VAT exempt person who is considered a farmer is allowed to claim an addition to the selling price of 4.8% (the farmers flat rate[24]) when selling timber to a VAT registered person who can in turn claim this as a deduction from their VAT liability. This flat rate does result in a cost to the exchequer in terms of VAT foregone but it is not possible to make any estimate of the cost in relation to forestry.

3.2.9: Tax Administration Cost

As there was no requirement (until the introduction of Section 35(1)(b) of Finance Act 2003) in the case of Income and Corporation Tax on woodland gains, for the taxpayer to report the amount of income exempted there was no need for any administration of the relief up until 2005. In the case of Stamp Duty, CGT and CAT relief the small number of cases results in only a minimum amount of administration – too small to be estimated.

[24] See brief note in Appendix IV

3.3: Future Tax Foregone

As outlined above the total tax foregone for the period 2000 - 2004 was estimated to be in the region of €52 million or €10.4 million p.a. However, as the major expansion in private planting did not take off until the late 1980s, the level of output from the private sector for the period covered was small, both in terms of volume and value, but the cost of tax foregone can be expected to rise in the future as this forestry comes due for thinning from around 2010 forward and for clear felling from around 2030 forward.

To get an indicative estimate of possible tax foregone in future years from the private sector a projection was run based on COFORD's projected softwood output volumes[25] which calculated future revenues, tax foregone on those revenues and the present value of the tax foregone.

The projected sales revenue for the period 2030 to 2034 was €674 million or €134 million p.a. and using a 30% average tax rate, the tax foregone was calculated as being €170 million or €34 million p.a. which equated to a present value in 2004 terms of €43 million or €8.6 million p.a. However, given that some of the forest owners are small farmers while others are corporate bodies, the use of a 30% average tax rate may overstate the estimate. It is also the case that while selling costs associated with the projected levels of output have been included, other costs that could be netted off against 'profits', e.g. roading and maintenance are not deducted as it is assumed that these costs have been met by grants or have already been netted off against revenues in prior years.

Using the same projections of output and assumptions but a tax rate of 12.5% the figure for tax forgone from the plantations owned by Coillte for the years 2030 to 2034 was calculated to be €16 million or €3.2 million p.a.

[25] Softwood volume projections are used as these will be the principal source of revenue from timber sales for the foreseeable future given the long growing period required for hardwoods. They assumed 12,500 ha afforestation p.a. until 2030, an average yield class of 18 for the timber crop (i.e. the crop puts on an average of 18 cubic metres per hectare per annum) and assumed that 40% of crops would not be thinned. In addition, using 2005 standing values for sales prices and deducting selling costs of €4.5 per cubic metre, price inflation of 0.5% and a discount rate of 5% were assumed.

Chapter 4 – Benefits from Woodland Output

The previous chapter provided an estimate the total cost to the State in terms of tax foregone from the operation of the woodland tax exemptions for the five year period 2000 to 2004. This chapter will estimate the value of the market and non-market benefits associated with forestry for the same period. The estimate of benefits will then be set against the estimates of costs to determine if the tax concessions generate an overall cost or benefit to the economy.

4.1 Summary of Benefits

Details of the net benefit to the economy from woodlands managed on a commercial basis for the period 2000 - 2004 are set out in Table 4.1. From this table it can be seen that total benefits (after deducting average deadweight of 98.4%) were estimated to be €18.6 million or €3.7 million p.a. Carbon sequestration at €115.21 emerged as the principal benefit, followed by sales of timber at €89.5 million p.a. and employment at €26.7 million p.a. with smaller amounts for the benefits of "net value added from processing", land, recreation, bio-diversity and landscape etc.

Table 4.1: Total Benefits of Woodland Relief

	2000	2001	2002	2003	2004	Total	Average
	€ million	€ million	€ million	€ million	€ million	€ million	€ million
Timber	86.80	77.60	85.80	98.40	99.10	447.70	89.54
Employment	24.38	23.76	26.45	29.52	29.57	133.68	26.74
Net Value Added	8.14	10.30	12.16	13.60	13.60	57.80	11.56
Carbon Sequestration	121.10	118.78	102.90	115.48	117.78	576.04	115.21
Recreation etc.	0.30	0.30	0.20	0.30	0.30	1.40	0.28
Land	-16.90	-16.60	-14.40	-16.10	-16.50	-80.50	-16.10
Gross Benefits	223.82	214.14	213.11	241.20	243.85	1,136.12	227.22
Deadweight %	0.988	0.987	0.984	0.985	0.975		0.984
Benefit net of Deadweight	**2.69**	**2.78**	**3.41**	**3.62**	**6.10**	**18.59**	**3.72**

The total benefit to the economy from forestry output is comprised both market benefits such as the value of timber harvested, employment and net output from timber processing and non-market benefits such as Carbon Sequestration, Bio-diversity, Landscape and Recreation, Water Quality, Health and Heritage. In the absence of operating markets and prices for the non-market benefits, determining their values directly is not possible but the use of a number of assumptions allows reasonable estimates to be constructed [26].

The estimates of benefits in the following sections are based on methods outlined in three recent Irish studies on forestry: two by Dr. P. Bacon - "Forestry: A Growth Industry in Ireland" (2003) and "A Review and Appraisal of Ireland's Forestry Development Strategy" (2004) and P. Clinch's "Economics of Irish Forestry" (1999)

[26] However, the introduction of emissions trading and the emergence of a market for emission permits has changed the situation in relation to the valuing the benefits of Carbon Sequestration.

and unlike the estimation of costs, annual data on the benefits does not exist in all cases. In the absence of annual data the most recent available information is used.

4.2 Market Benefits

The market benefits from forestry output estimated below are the value of timber harvested, the value of employment in processing and the net value added from processing. The following sections will estimate the contribution under each of these headings for the period 2000 to 2004 before moving on the estimating values for the non-market benefits. These two sets of estimates will then be combined to get an over all total of the benefits from forestry.

4.2.1 Value of Timber Produced

The value of timber harvested in 2000 was €86.8 million increasing to €99.1 million by 2004, (an average of €89.5 million p.a.). These totals were derived by summing figures supplied by Coillte in relation to its own output with estimates of the value of timber produced by the private sector calculated above to get an overall value for timber harvested each year.

Table 4.2: Value of Timber Harvested

	2000	2001	2002	2003	2004
	€ million	€ million	€ million	€ million	€ million
Coillte	84.5	75.3	82.3	91.2	91.7
Private Sector	2.3	2.3	3.5	7.2	7.4
Total	**86.8**	**77.6**	**85.8**	**98.4**	**99.1**

Source: Coillte and ITC

The estimate of the value of timber harvested by the private sector is based on the standing value of the timber (i.e. before harvesting) and it is assumed that the cost of the inputs to the production of this output have been met by the proceeds of previous thinnings etc. and that all of this total can be considered to be value added. In the case of the timber harvested by Coillte the value relates to the actual value invoiced to final users. While invoice value does not equate with value added it is the closest approximation one can obtain as there are no means to adjust the value in this case. It can be taken that this approach will almost certainly overstate the value added to some degree but if it assumed that as with private sector output that the cost of all inputs to the production of this output have been covered by the proceeds of previous thinnings then the overstatement should be minimised.

4.2.2 Value from Employment in Forestry and Timber Processing

The average annual benefit arising from employment in the forestry and timber processing sector amounted to €26.7 million. This figure was obtained by multiplying an estimate of the number of people employed in the sector by an appropriate wage rate and reducing the total by a factor to account for the shadow price of labour. It can be argued that this "upstream" benefit from employment in processing should not be included on the grounds that the processing industry could survive on imported raw materials. However, in the case of timber and timber processing the relatively low value and bulky nature of the raw material make it unsuitable for transportation over long distances. For this reason manufacturers in these industries tend to locate in relatively close proximity to their raw material source. It is therefore valid to count additional value from employment in the processing of forestry output as an additional benefit as in the absence of the raw material it is unlikely that the industries in question (especially the multinational manufacturers) would have established their operations in Ireland and equally unlikely that they would have located in the relatively more remote areas where they are to be found.

Exact figures on the number of people employed and wages in forestry and timber processing sector are difficult to compile on an annual basis, however, using the CSO's Census of Industrial Production[27] (CIP) and estimates prepared by other researchers it is possible to make an approximation of total employment. The CIP data related to employment covered by the General Industrial Classification of Economic Activity Codes within the European Communities (NACE) 201 to 2051 i.e. NACE Code 201 sawmilling and planing of wood, impregnation of wood, NACE Code 202 Manufacture of veneer sheets; manufacture of plywood, laminate board, particle board, fibre board etc., NACE Code 203 Manufacture of builders' carpentry and joinery, NACE Code 204 Manufacture of wooden containers and NACE Code 2051 Manufacture of other products of wood

Numbers Employed

CIP data for the years 2000 to 2003 (the most recent available) show that the total employed in the timber processing sector was 6,249 in 2000 rising to 6,870 in 2003. Bacon[28] quoting research by Philips (2003)[29] suggests that there were a further 2,375 people employed in crop establishment and 1,405 employed in harvesting and logistics[30]. Figures supplied by the Craft Council of Ireland (based on a national survey of craft workers carried out by Platinum Consulting Group) show that there were 78 Full-Time Equivalents employed in wood related industries in 2004 and it is assumed that all of them use Irish wood as their main raw material.

Table 4.3: Numbers Employed in Forestry and Timber Processing

	2000	2001	2002	2003	2004
NACE Code					
201	1,442	1,374	1,345	1,607	-
202	737	732	737	705	-
203	3,151	3,048	3,276	3,416	-
204	418	394	374	415	-
2051	501	535	620	727	-
Establishment	-	-	-	2,375	-
Harvesting etc.	-	-	-	1,405	-
Crafts	-	-	-	-	78*

Sources: CSO (2002/03/04/05), Table 1, Bacon (2004) and Platinum Consulting (2004)
*Full Time Equivalents

In the absence of full data for all years under consideration it is assumed that the figures for establishment, harvesting etc. and crafts are reasonable estimates of

[27] It should be noted that the CIP data only includes operations engaging three or more people therefore it is possible that these estimates may understate true employment as there are many small firms in this sector.
[28] Dr. P. Bacon (2004), A Review and Appraisal of Ireland's Forestry Development Strategy
[29] Philips, H. (2003), Economic Impact of Forestry. Unpublished paper, COFORD
[30] These estimates do not include any estimate of the labour input by farmers in growing crops on their own land.

average employment over the period (i.e. that annual employment does not vary greatly). These totals can therefore be used as approximations of the level of employment for the years 2000 – 2004. It is also assumed that the totals for employment in the sectors covered by NACE Codes 201 to 2051 for 2003 are reasonable approximations of employment in 2004.

Employment in crop establishment would normally be viewed as an input to the production of the timber output and not considered a benefit. However, the 1946 Forestry Act imposes an obligation on the owner of woodland to replant after clear felling. Therefore, the harvesting of timber generates additional planting employment. In recent years the amount of reforestation has been roughly equal to the level of afforestation. For this reason half of the employment in crop establishment is included as a benefit.

The value of timber harvested by the private sector has been estimated using the standing price of timber i.e. before felling and transportation. For this reason employment in harvesting and logistics of this output is considered as a benefit in addition to the value of the timber itself. However, the value of timber harvested by Coillte's already includes harvesting and logistics as an input thus the employment involved cannot be considered as an additional benefit. For this reason only the percentage of the employment in harvesting and logistics equal to the private sector share of total output is included as a benefit (this assumes that employment per unit output is the same for the private sector as for Coillte).

These assumptions indicate that average employment was 7,726 p.a. However, for NACE 203 (manufacture of builders' carpentry and joinery) only 34% of the wood used is Irish due to the unsuitability of native wood for some applications in the building industry. If it is assumed that percentage of the employment processing Irish wood in this sector is equal to the percentage of Irish wood used then the average number employed is reduced to 5,600 p.a.

Wages

Using data on wages from the CIP for the processing sector and applying the average wage rate from the sawmilling sector (the lowest skilled sector) to those involved in establishment and harvesting while using annual sales as a proxy of income for the crafts sector the total average annual wage bill for these employees amounts to €133.7 million.

Net Benefit of Employment

The total employment and wage benefit cannot be attributed in full to the forestry sector as it is likely that some, if not all, of these people would have found employment in other sectors of the economy. Given the fact that Ireland is essentially operating at full employment the benefit from the forestry sector to the economy should be set at zero. However, Bacon (2004) points out, forestry is concentrated in the less developed areas of the country where there is less likelihood of finding alternative employment and it can be argued that existing rural jobs displaced through increased forestry activities will be replaced by higher paid and permanent positions further benefiting rural renewal. Applying a shadow price of labour of 80% as currently used by Forfás for evaluation of projects supported by the IDA etc. in less developed areas the average annual employment benefits from forestry are reduced to 1,120 employees and the wage bill falls to €26.7 million.

4.2.3 Net Value Added in Timber Processing

The net value added from forestry sector processing was estimated as €8.1 million in 2000 rising to €13.6 million in 2003 (an average of €11.5 million p.a.). These estimates of net value added were derived by applying a methodology outlined in Bacon (2003) to data from the CSO's Census of Industrial Production (CIP)[31] and then applying a "shadow-cost" at 80% (as in the case of the benefits from employment) to the estimate. This is consistent with the Forfás methodology used for evaluation of projects supported by the IDA in less developed areas. Given that the Irish economy is currently operating at essentially full employment the convention in cost benefit analysis would be that this benefit (as with employment) should be subject to a shadow cost of 100% but given the location of these industries in the les developed areas of the country a case can be made for including the associated benefits albeit at a shadow cost of 80% as utilised by Forfás.

In his calculations Bacon (2003) began with the values of the remainder of net output from the CIP (i.e. gross output less the value of industrial inputs and wages and salaries) which amounted to €54 million (or 22% of gross output) in the sawmilling sector and €43.2 million (or 25.7% in the panelboard sector). To get an estimate of profit or the value created in each sector he assumed that interest and depreciation amounted to 50%. In the sawmilling sector he assumed that 75% of this value created accrued to Irish residents and in the panel board sector he assumed that 10% of this value accrued while he assumed a flat rate of 12.5% tax on profits. This resulted in an estimated contribution from the sector of €25.7 million for 2000.

Table 4.4: Remainder of Net Output from Timber Processing

	2000	2001	2002	2003	2004
NACE Code	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**
201	54.1	79.7	88.7	100.2	-
202	43.1	29.5	30.9	36.8	-
203	56.2	60.7	82.8	76.9	-
204	6.7	6.6	8.3	9.5	-
2051	9.4	9.2	12.7	17.9	-

Sources: CSO (2002, 2003, 2004), Table 1

This study expanded the number of industries covered to include those in NACE Codes 203, 204 and 2051 and applied Bacon's methodology to CIP data for 2001 and 2002[32] to estimate the contribution of timber processing for the rest of the period. The values for industries in NACE Codes 203, 204 and 2051 were combined and it was assumed that as with the sawmilling sector, 75% of the value created accrued to Irish residents and that 34% of the output of industries in NACE Code 203 could be attributed to Irish sourced timber. As outlined above the estimates obtained were then "shadow-costed" at 80%.

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[31] As before it should be noted that the CIP data only includes operations engaging three or more people therefore it is possible that these estimates may understate net output as there are many small firms in this sector

[32] For 2003 and 2004 the value for 2002 was used.

4.3 Non-Market Benefits

"Europe's forests are now providing many non-wood products and services, in such areas as carbon sequestration, biodiversity and in providing recreation space for an increasingly urbanised population.[33]"

The absence of operating markets and associated prices create difficulties for the determination of monetary values of such benefits, however, in the case of the benefits associated with carbon sequestration the emergence of markets for emission permits has led to the establishment of a market price for this benefit – whose value was previously estimated.

The values of estimates of non-market benefits reported in various studies in this area are generally expressed in terms of an amount per hectare. Therefore, before estimating these benefits it is necessary to determine the total area from which the output evaluated in the costs section was harvested. Table 4.5 shows the area harvested by Coillte for 2000 to 2004.

Table 4.5 Coillte harvesting figures: 2000 - 2004

	2000	2001	2002	2003	2004
Clearfell (ha)	9,119	9,217	7,553	8,642	8,557
Thinning (ha)	14,312	10,665	12,735	9,337	11,524
Total (ha)	**23,431**	**19,882**	**20,288**	**17,979**	**20,081**

Source: Forestry Service

Before using these totals to derive estimates of the value of the non-market benefits associated with the output for each years the total Coillte figures have to be adjusted upward to take account of the output of the private sector and the area of thinnings has to be subsequently adjusted downward to reflect the fact that only some of the timber is being removed from these areas while the majority of the timber remains standing[34].

Table 4.6 Coillte & Private Harvested Hectares; 2000 -2004

	2000	2001	2002	2003	2004
Clearfell (ha)	9,391	9,521	7,907	9,315	9,297
Thinning (ha)*	1,327	991	1,200	906	1,127
Total (ha)*	**10,718**	**10,512**	**9,107**	**10,220**	**10,424**

Source; Forestry Service and own calculations

*Equivalent hectares

The results show that the annual average area harvested was just over 10,000 ha across the period.

[33] Mr. Joe Walsh T.D., Minister for Agriculture and Food, opening a European Conference on the Forest and Forest Product Industry in Europe, in Dublin, April, 2004

[34] Private volume was on average 5% of the Coillte volume and therefore 5% is added to the Coillte area. This assumes that output per hectare is the same as in the public and private sectors. Each round of thinnings produces c.9% of total final volume output of a hectare. The total area thinned is reduced to reflect this.

4.3.1 Value of Sequestered Carbon

The value of carbon sequestered from forestry (assuming a permit price of €22.50 per tonne) was €121 million in 2000 and €117.8 million in 2004 (an average of €115.2 million p.a.). As outlined earlier the term carbon sequestration (storage) refers to the ability of trees to absorb carbon from the atmosphere in the form of carbon dioxide (CO_2) and store it as timber where it remains until the wood or products made from the wood decay and is one of the principal non-market benefits associated with forestry. This ability creates a positive externality through the removal of a harmful "greenhouse gas" which has become of value to Ireland since EU Environment Ministers agreed to cut emissions of greenhouse gases from their 1990 levels by 2010. This is to be achieved by "burden sharing" between member states as part of the Luxembourg Agreement e.g. Portugal is allowed to increase emissions by 27% while Germany and the UK must cut theirs by 21% and 12% respectively. Ireland is being allowed to increase its emissions by 13% over the 1990 levels.

Recent rapid economic growth has resulted in Ireland already using up 10% of its 13% allowance with no sign of the rate of growth in emissions slowing. If Ireland breaches its targets it will be required to purchase carbon credits form other member states, however, the calculation of countries emissions will be net of the carbon sequestered by forests. Therefore, the ability of trees to sequester carbon provides a real economic benefit to society.

Approached to Valuing Carbon Sequestration

Three approaches to valuing the carbon sequestration and storage benefits of forests identified by Clinch (1999) are;

- The Damage Avoided Approach – this values a tonne of carbon sequestered by the cost of the damage that would have been done by global warming if that tonne of carbon had not been sequestered.

- The Offset Approach – this measures the value of a tonne of carbon sequestered by a forest by the next cheapest alternative method of sequestering carbon. Since CO_2 reduction technology does not exist, the tonne of carbon sequestered is valued by the cost of substituting a non-carbon fuel for a fossil fuel at the margin.

- The Avoided Cost of Compliance Approach – this is similar to the offset approach and measures the value of a tonne of carbon sequestered by the avoided cost of compliance with a global CO_2 emissions reduction policy. In the case of a system of tradable carbon emissions permits (such as Kyoto), the value of a tonne of sequestered carbon is measured by the cost of the permits which would have been purchased if the tonne of carbon had not been sequestered or by the income received from the selling of permits i.e. the value of a tonne of carbon sequestered equals the market price of a permit to emit one tonne of carbon.

Both Bacon and Clinch agree that the avoided cost of compliance approach (e.g. tradable permits) is the correct approach to adopt for valuing the benefits of carbon sequestration, and using this approach Clinch (1999) valued the benefits of the

Forestry Strategy at €46 million (using a 5% discount rate) while Bacon (2003) estimated a social benefit of €31.65 million p.a. over the period of the forestry strategy from 1996 to 2035[35].

Estimating Carbon Storage per Hectare

Cannell and Cape (1991) estimated the mean annual carbon storage of a conifer stand of yield class 18[36] to be 2.5 tonnes of carbon per ha while research by COFORD in 1999 estimated that the average rate of carbon storage in Irish forests of pure Sitka spruce to be in the region of 3.36 tonnes per ha per annum (based on an average yield class of 16).

Bacon (2004) describes more recent research undertaken by COFORD which suggests that the annual sequestration of carbon of a typical hectare of new forest as it grows to be 3.5 tonnes. In preparing this estimate COFORD assumed that the hectare in question is composed of 80% Sitka spruce and 20% beech. The conifers were deemed to have a Yield Class 16 and undergo intermediate thinning (at 20, 25 and 30 years.) For the beech plantation a yield class 4 was assumed and no thinning was undertaken. Average growth rates based on outturns from the Coillte estate for Sitka spruce and beech were used. The storage estimate (net of emissions from soils, vegetation and thinning) of carbon over the full growing period amounted to 165 tonnes or 4.125 tonnes p.a. However, as these results assumed that all hectares were fully stocked, Bacon reduced the results by 15% to allow for non-planted areas etc. (in line with parameters in the CARBWARE model for estimating carbon storage in Irish forests)[37] which results in an average annual carbon sequestration of 3.5 tonnes per ha. This is equivalent to 12.84 tonnes of CO_2 per ha.

Using this annual value for CO_2 storage over a 40 year rotation and a permit price of €22.50 per tonne the benefit of carbon sequestered in the output of timber was €121.1 million in 2000 and €117.78 million in 2004 (an average of €115.21 million per annum). The price of €22.50[38] was obtained from the on-line quotation service of the European Climate Exchange (ECX), who's Carbon Financial Instruments (ECX CFIs) are listed on the International Petroleum Exchange (IPE). ECX products account for approximately 70% of all exchange-traded European emissions business, and approximately a third of the E.U. market's total share. When trading began in April 2005 carbon credits were trading at about €17 per tonne this figure has increased since and contracts were trading between €22 and €23 per tonne on 03 October. The mid-point of 22.50 was used in the above calculations.

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[35] Assuming a permit price of €17.50 per tonne, net carbon storage of 129.2 tonnes per ha by and an average afforestation level of 14,000 ha p.a. The average afforestation level is the average over the period 1996 – 2003; the estimated price for excess carbon is a mid-point value for green credits, from a range of estimates from the 'Carbon Market Europe Monitor' and the ESRI; and the estimate for net carbon storage is taken from research conducted by COFORD, UCD.

[36] The yield class of a plantation refers to the mean annual growth increment in terms of cubic metres per hectare. Therefore the volume of timber in a stand of yield class 18 increases by 18 cubic metres per hectare per annum.

[37] From Bacon (2004)

[38] This is the only available price at the moment but it is possible that the State may be able to obtain carbon credits at a lower price when it come to meeting targets set for the period to 2012.

4.3.2 Valuing Forest Recreation, Landscape and Bio-diversity.

In two recent Irish studies (P. Clinch's "Economics of Irish Forestry" (1999) and Dr. P. Bacon's "A Review and Appraisal of Ireland's Forestry Development Strategy" (2004)) the recreation, landscape and bio-diversity value of the Irish forestry estate was estimated at €21 million p.a. and €39 million p.a. respectively. In the case of the recreation, landscape and bio-diversity value of the area harvested in 2000 was found to be €288k and €261k in 2004 (based on assumptions made by Clinch (1999)).

Clinch (1999) used a Contingent Valuation Model (CVM) to estimate the recreation, biodiversity/wildlife and landscape values of Irish forests. This method is described in Clinch (1999) as the only direct non-market valuation approach. It involves "collecting preference information by asking households how much they are willing to pay for some change in the provision of a public good, or the minimum compensation they would require if the change was not carried out"[39]. He found that in Ireland the mean willingness to pay for recreation, landscape etc. was €18.41 (£14.50) per household. Multiplied by the total number of households at the time Clinch derived a recreation value for Irish forestry of €21.27 million (£16.75m) p.a. Updating Clinch's estimate for the increase in the number of households (an 18.5% increase up to Q3, 2003, according to the latest CSO figure available) gives an estimate of €25m p.a. for forest recreation etc. This €25 million estimate is based on extra recreation due to afforestation growth rates in the forestry strategy. However, present growth rates are closer to 14,000 ha p.a. rather than the 20,000 ha p.a. in the strategy. When the estimate is revised to account for this planting shortfall the figure falls to €17.5 million p.a.

Bacon (2004) adopting a model which had been applied in the UK and using data from four selected forest sites (Wicklow/Dublin uplands, Mid-East Cork, Pettigo and Lough Allen), obtained a willingness to pay per person visiting in 2003 prices of €3.34, giving a recreation value for the total Irish Forestry estate of €37.6 million per annum. He also estimates the bio-diversity benefit of the current estate at €5.6 million with an additional €1.6 million per annum accruing from the afforestation programme estimate if the 20,000 ha goal in the strategy is reached. This translates into €1.12m p.a. with the current afforestation levels of 14,000 ha. He points out that alternative approaches suggest that this may be an underestimate of the potential contribution. In relation to the benefits attaching to landscape Bacon (2004) concluded that there is potential for a positive impact if guidelines strictly applied but some earlier inappropriate planting offsets this so he assigns a zero impact overall.

Not all forestry provides the same benefits in terms of recreation, landscape and bio-diversity due to issues such as location, accessibility, ownership, existence of facilities etc. Some forests are visited more than others and Hutchinson and Chilton (94) in their CVM study estimated that over 50% of Irish recreational forest visits took place on sites covering only 0.7% of the forested area. These are likely to be national forest parks designed specifically for recreation, not the private farms availing of the tax exemption and it is unlikely that many visits will be made to areas set aside for commercial forestry. It is almost certain that most private farms will be not open to recreational visits. However, forestry even if not visited for recreational purposes still possesses a landscape and bio-diversity value and so a value should be assigned to the

[39] (Johansson, 1993), in Clinch (1999) page22

benefit associated with the forestry output for the period 2000 to 2004. If it is assumed that all forestry provides the same benefits (even though this will tend to overstate the benefit) the value of the area harvested lies between €288k and €731k in 2000 and between €261k and €661k in 2004 depending on whether one adopts Clinch's or Bacon's estimates.

4.3.3 Shadow Price of Land

Land is a key factor of production and its importance is increased by the fact that its supply is, effectively, fixed. It is a key input into forestry production and the cost of land should be deducted from total benefits in arriving at the overall benefit to society. However, Clinch (1999) argues that the price of land is distorted due to CAP etc. and is no longer a true reflection of the opportunity cost to society of using the land. In addition, this exemption has the effect of increasing the net private return to using land for woodlands and so further distorts the working of the market. In the absence of being able to rely on the market value of land to reflect its cost he suggests estimating the opportunity cost of land used for forestry by using the value of agricultural output forgone.

Previous research by the ESRI estimated the social value of agricultural output, on a potential afforestation site, to be €100 (£79) per ha[40]. Discounting this by 5% over 300 years[41] produces a shadow price of €1,580 per ha. This calculation is carried out to account for the fact that the 1946 Forestry Act requires that land once afforested must be reforested after clearfelling – i.e. the loss to society of the highest foregone alternative is not measured across the 40 year growing cycle but for perpetuity. Using the 300 year discounted value of a hectare of land produces in a shadow price of land used for forestry of €16.9 million in 2000 and €16.5 million in 2004, or an average of €16.1.

4.3.4 Other Benefits

Bacon assigns a zero overall value to the aggregate impact of afforestation on water quality, health and heritage. Clinch does include an estimate for the social 'cost' of water but he notes water is a very difficult externality to measure and that this estimate is tentative therefore it will not be applied in this study.

4.4 Deadweight

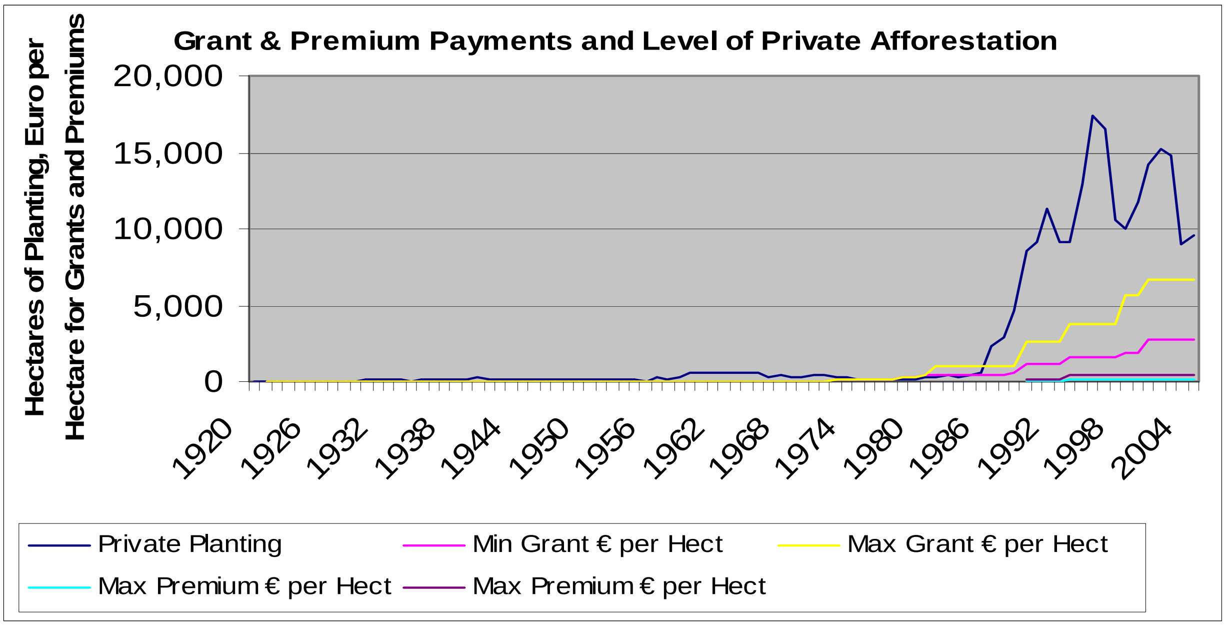
Deadweight is a critical issue in this study as it needs to be established whether or not the output of timber would have occurred without the introduction of the tax exemption, before one can assign the benefits of that output against the costs incurred. It is contended by some researchers that the existence of the tax concession has had no measurable effect on the level of afforestation i.e. that deadweight should approach 100%. An econometric study in Northern Ireland[42] found that tax incentives were not a significant explanatory variable in determining private afforestation while two related Irish studies[43] showed that the take-up in private afforestation in Ireland

[40] The Economics of Biomass, Fitzgerald J. (1999)
[41] Clinch (1999) uses 300 years as beyond this the discount factor does not change significantly for a positive discount rate.
[42] Kulla
[43] McCarthy ( ) and McCarthy, Matthews and Riordan (2002)

occurring around 1987 – 1989 was due to changes in grant support rather than the introduction of the tax exemption.

They found that the economic significance of the expected forestry market margin (i.e. financial gain from sale of future timber output) on the decision to afforest was very limited. A 1% increase in the margin would only increase afforestation by 0.03%. A tax exemption acts as an increase in the after tax margin. Therefore an effective tax rate of 13% for example (as estimated earlier for the farming sector), would imply a decrease of 13% in the after tax margin if the tax exemption was discontinued. This would only have a minor effect on afforestation: a decrease of 0.39%. They also note that most forestry experts concur that the vast majority of farmers do not consider the forestry market margin when deciding to plant.

The lack of reaction of afforestation to the introduction of woodland relief can also be seen diagrammatically. The following chart traces the nominal level of grant and premium payments against level of private afforestation from 1920 to 2004. It can be seen that there was no response in level of private planting in 1969 when tax relief was introduced for income (or in 1976 when it was extended to corporate profits)[44] and that private planting only takes off when the grants begin to increase significantly and when premiums are introduced.



Source: Forestry Service

Given the diagrammatic evidence which shows no response in the level of private afforestation to changes in the tax regime allied to the results of research carried out by Kulla, McCarthy etc. it would appear that the influence of the tax relief on private afforestation has been minimal and that the level of deadweight is correspondingly high.

However, account needs to be taken of the fact that the premium payments which are credited with being one of the major contributors to increased afforestation are themselves tax free and any reduction in the value of these payments through taxation

[44] See Appendix II for detail of the evolution of the relief over time

would be expected to have a negative impact on afforestation. The Irish studies referred to above[45] found that the economic significance of the forestry subsidies was very high. A 1% increase in the margin would increase afforestation by 2.12% (only the value of the planting grant had a higher impact). A tax exemption acts as an increase in the size of the premium. Therefore an effective tax rate of 13%, for example, would imply a decrease of 13% in the value of the premium if the tax exemption was discontinued. The research predicts that this would only have a major effect on afforestation: a decrease of 27.6%. So while the impact of the tax relief on future profits may be very low the tax free status of the premium payments has a large impact. This effect may become more marked going forward with the introduction of the single farm payment as the principal means of income support for agriculture. The single farm payments will be assessable to tax in the normal way while premium payments for forestry will continue to be tax free.

Estimating Deadweight

Some researchers suggest that one can get an estimate of deadweight by surveying those availing of the relief. However, while this approach may be possible it is subject to a "respondent effect" in that those surveyed have a vested interest in responding in a particular way and the scope of such a survey would be beyond the scope of this report.

In the absence of a definitive figure for deadweight one extreme position to take in relation to the benefits from the timber produced in the period 2000 to 2004 would be to assume that as the harvest in those years was planted 40 years ago this was before the introduction of the relief and therefore deadweight for this output should be 100%. While this may be an extreme view it is a reasonable one in relation to apply to the output from Coillte given that its planting in the past was determined by Government policy and the amount of money voted to the forestry service not on the availability of tax concessions.

In the case of private producers the research quoted above suggests that the economic significance of the expected forestry market margin was very limited, the avoidance of tax at an effective rate of 13% would change afforestation by 0.39%, suggesting a level of deadweight in the private sector of 99.6%. However, when the significance of the premium payments is included the deadweight in the private sector declines to 72%.

In addition, some of the output from the private sector comes from bodies set up expressly to take advantage of the favourable tax provisions relating to forestry. If one assumes that their output is 100% dependant on the existence of the tax relief then their level of deadweight amounts to 0%. It is not possible from the data available to determine how much of the private sector output comes from such bodies and how much comes form other private producers but to construct an estimate of overall deadweight it has been assumed that these bodies are currently responsible for just 1% of total output[46].

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[45] McCarthy () and McCarthy, Matthews and Riordan (2002)

[46] If their share of output is lower the deadweight calculated will be understated and vice versa

If these estimates of deadweight for each type of producer are weighted by the output from each sector in each year the figure for total deadweight in 2000 becomes 98.8% and 97.5% in 2004 - an average of 98.4% p.a.

4.5 Total Benefits

Total gross benefits estimated above amounted to €1,126 million for the period or an average of €225 million p.a. Applying the estimated values for deadweight obtained in the previous section to these totals results in total benefits net of deadweight of €2.68 million in 2000 rising to €5.98 million in 2004, an average of €3.68 million p.a..

In the following chapter the estimates of total costs and benefits will be subjected to sensitivity analysis and combined to see if they yield an overall net benefit to the economy. A number of possible options will be presented before a final conclusion is made on whether this relief should be continued or not.

Chapter 5 – Results & Conclusions

The previous two chapters estimated the total cost to the State in terms of tax foregone from the operation of the woodland tax exemptions for the five year period 2000 to 2004 and the value of the market and non-market benefits associated with the output of forestry for the same period. In this chapter these estimates will be combined to determine if the tax concessions generate an overall cost or benefit for the economy and sensitivity analysis will also be carried out on the estimates to see how robust they are.

5.1 Summary of Results

Combining the total costs in terms of tax foregone with the total benefits adjusted for deadweight shows that costs exceed benefits by €24.9 million for the period 2000 to 2004, an average of €5 million p.a.

Table 5.1: Net Cost/Benefit of Woodland Relief

	2000	2001	2002	2003	2004	Total	Average
	€'000	€'000	€'000	€'000	€'000	€'000	€'000
Total Tax Foregone	8,544	7,871	8,125	9,789	9,187	43,516	8,703
Total Benefits less Deadweight	2,686	2,784	3,410	3,618	6,096	18,594	3,719
Net Cost/Benefit	**-5,858**	**-5,087**	**-4,715**	**-6,171**	**-3,091**	**-24,922**	**-4,984**

This would initially suggest that the relief does not provide an economic return and should be discontinued, given that the costs of woodland tax relief exceed the attributable benefits. However, even using conservative assumptions regarding the value of benefits and applying a very high level of deadweight, the outcome is very finely balanced. As the output from the private sector rises going forward the costs in terms of tax foregone will rise but so too will the benefits and the level of overall deadweight will be expected to decline. The combined affect of these future changes should be a positive net benefit arising from the operation of this relief. In the event that the woodland relief continued to result in a net cost to the exchequer it may be that the provision of the tax relief is the lowest cost (most effective) means of obtaining these overall benefits in any case.

5.2 Sensitivity Analysis

The results obtained for the estimates of costs, benefits and deadweight in the previous chapters have been constructed on a number of assumptions. The impacts on the estimates obtained of changes in some of these key assumptions are examined in turn below.

5.2.1 Sensitivity Analysis of Costs

The costs of the Stamp Duty exemption are based on actual returns and as the CGT estimates are derived from these they are unlikely to vary greatly. Given that Coillte dominate the corporate sector and as details of the tax foregone on its profits are published, it is unlikely that the true cost for this sector will depart greatly from that estimated. The zero cost assumed for VAT and administration is also reasonable (there may be a cost associated with the availability of the "farmer's flat rate" which while not capable of being estimated is likely to be small given the low level of sales by the farming sector to date).

The key assumptions which will impact on the overall level of costs are the selling price of private sector output and the effective rate of tax applied to the farmers. If the non-corporate private sector output is composed mainly of low value thinnings then the tax foregone will be reduced while a higher effective rate of tax on farmers would increase the cost.

If the selling price obtained by the private sector was based on the average price for the four lowest grades of timber rather than the average price for all grades, the total cost in terms of tax foregone – all other things being equal – would be reduced to €41.7 million for the period or €8.3 million p.a.

If on the other hand the selling price obtained by the private sector was left unchanged but the effective tax rate applied to farmers premium income was increased from the estimated 13% to an average of 30% then, the cost in terms of tax foregone would be increased to €56.2.million for the period or €11.2 million p.a.

5.2.2 Sensitivity Analysis of Benefits

The value of the market benefits are based mainly on figures compiled by Coillte and the CSO. Given that Coillte dominates output in the sector and the value of its output is known the estimates derived from these totals are most likely reliable. However, "net value added" and the wage rates used to value the benefit were estimated for 2003 and 2004 as being equal to the values for 2002 obtained from the Census of Industrial Production (C.I.P.), whereas it is likely that these total would have increased going forward. If the increases in wholesale price index and the industrial wage index respectively for the timber processing sector are applied to these figures the total benefits rise to €18.5 million for the period, or €3.7 million p.a. and the gap between costs and benefits after deadweight falls to €25 million or €5 million p.a.

The estimation of non-market benefits due to their very nature is fraught and obtaining estimates based on Irish research provides an extra difficulty. Work by COFORD has established reliable estimates of the carbon storage capacity of Irish timber but the value of the benefit is dependent on the value selected for sequestered carbon. The mid-point value selected was the estimated price for green credits, from a range of estimates from the 'Carbon Market Europe Monitor' and the ESRI. However, if the carbon stored in the timber produced is valued at €40 per tonne (the interim value outlined in the EU Directive on emissions trading) the total benefits after deadweight rise to €26 million for the period, or €5.2 million p.a. and the gap between costs in terms of tax foregone and these benefits falls to €17.5 million or €3.5 million p.a. At a value of €100 per tonne the total benefits rise to €51.5 million, or €10.3 million p.a. and benefits after deadweight exceed total costs by €7.9 million or €1.6 million p.a.

The value of the benefits from recreation, landscape etc. may be excessively conservative and the value of such benefits can be expected to rise with increasing population, urbanisation and congestion. However, given their low value relative to the other benefits they would not affect the overall result even if they were doubled.

The value for the opportunity cost of land was used by Clinch in 1999 and will be relied upon in the absence of any other estimate.

5.2.3 Sensitivity Analysis of Deadweight

The key assumption affecting the outcome of this study is the degree of deadweight selected. The average value of deadweight used above was 98.4%. It was arrived at by assuming that the output of Coillte was totally independent of the tax relief while the output of the non-IForUT investment companies was completely dependant on the existence of tax relief, i.e. deadweight of 100% and 0% respectively. The estimate for deadweight for the remainder of private sector output was calculated to be 72%. These values were then weighted according to their share of output in each year to reach the overall value.

However, the estimate of deadweight in the (non unit trusts and investment company) private sector associated with the gains from forestry (i.e. future profits) at 72% may itself be overstated. The studies and the diagrammatic evidence support the view of high deadweight showing no response in the level of private sector planting to the introduction of tax relief in 1969 and planting only taking off when grants and premium payments became available. This lack of response in private planting to the introduction of tax concessions may have been due to a lack of capital in the farming sector and an inability by farmers (or indeed any investor) to obtain loan finance for an investment with a 40 year maturity rather than showing that the tax concessions are unimportant. As well as lacking capital, farmers would also have found themselves without any income from their land for the duration of the investment, regardless of tax status. In such a situation it is hardly surprising that take up rates were low.

With the widespread introduction of EU backed, 100% planting grants and 20 year premium payments (for farmers) the afforestation decision changed fundamentally. Farmers were freed of the necessity to meet the costs upfront and received a guaranteed income stream. The decision now became one between competing forms of (mainly EU supported) land use. In choosing between alternatives, the tax-free status of forestry gains may be an important consideration which would imply a lower level of deadweight for this sector.

Even if the estimates of deadweight for each sector remain unchanged the increasing share of output coming form the private sector will cause the total level of deadweight calculated using the above assumptions to decline. If (non unit trusts and investment company) private sector output accounted for half of all output (as it is expected to in the future) the level of deadweight would fall to 86% while increased output share from the unit trusts and investment companies would reduce it even further.

Even using the existing totals, if deadweight was reduced to 95%, total benefits would rise to €56.3 million for the period or €11.3 million p.a. and benefits after deadweight would exceed costs by €12.2 million or €2.6 million p.a.

5.3 Social Cost of Public Funds and the Multiplier

In addition to examining the actual costs and benefits arising from State support for forestry one can also consider the appropriate value to use for the social cost of public funds and what value of multiplier to apply[47].

Social Cost of Public Funds

Because taxes tend to be distortionary, the cost of raising funds in terms of the overall welfare of the economy will, on average, exceed the monetary value of the funds raised. This difference between the social cost of raising public funds and the actual amount raised is described as the deadweight loss of taxation. Honohan (1996) estimated that the social cost of public funds in Ireland was 1.5 i.e. the social cost of each €1 of tax raised was €1.5. In the case of forestry relief as the revenue foregone will have to be raised elsewhere through taxation the cost of the relief should be increased to reflect the full social cost of the relief. Bacon (2003) argues that because taxes in Ireland are now less distortionary and the public finances have been in a strong position over the medium term that a more appropriate a ratio would be 1.3 to 1 and he uses this lower value in his calculations. In this analysis a value of 1.25, as used in the Forfás model will be applied.

The Multiplier

In addition to the direct effects of forestry output, secondary effects also occur as the wages earned are re-spent and as inputs to the sector are paid for, just as a stone dropped into a still pool leads to ripples across the surface of the water. The net result is that the total effect of an investment can be a multiple of the initial amount. Bacon (2003) argues "that the economic boom of recent years has meant that, as spare capacity in the economy is brought into production, the net value of these benefits has tended to fall since an increasing proportion represents displaced – rather then additional economic activity". However, he goes on to say that "this aggregate view ignores the fact that economic activity is increasing regionally concentrated and many areas continue to experience much less vibrant economic conditions and that even where no additional employment is created, higher value employment may result". He arrives at an estimate for increased economic activity by using the multipliers shown in Table 5.2. In this analysis only the indirect effects will be included at the induced effects are considered too remote to include as being attributable to the tax relief.

Table 5.2: Forestry Multipliers

	Indirect	Induced	Total effect
Output	0.271	0.721	1.992
Income	0.168	0.44	1.608
Employment	0.23	0.41	1.64

Source: Ní Dhubháin et al (1993).

If these values for the social cost of public funds and the multiplier are applied to the results of the analysis above the magnitude of the figures change but the overall outcome as shown in Table 5.3 overleaf remains the same, albeit with an increased total cost for the period.

[47] For a more detail discussion on this issue see Bacon (2003)

Table 5.3: Tax Costs of Woodland Relief							
	2000	**2001**	**2002**	**2003**	**2004**	**Total**	**Average**
	€'000	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**	**€'000**
Total Tax Foregone	10,680	9,839	10,156	12,236	11,484	54,395	10,879
Total Benefits less Deadweight	2,955	3,061	3,790	4,023	6,775	20,603	4,121
Net Cost/Benefit	-7,725	-6,778	-6,366	-8,213	-4,709	-33,792	-6,758

5.4 Recommendations /Options

The following options for the future of the relief can be considered.

1. Do nothing. In this case the cost in terms of tax foregone would continue at its present relatively low level but would begin to climb, especially from around 2030 onward as the volume of clearfell from the private sector comes on stream. However, the corresponding benefits would also rise and the level of deadweight would be expected to fall. This should result in an overall net gain.

2. Scrap the relief in total for everyone with immediate effect. This would save relatively little in terms of tax foregone immediately but the savings would be expected to rise going forward (assuming that afforestation by the private sector would continue at present rates and that thinning would be carried out on the existing forestry estate). While a certain number individuals might be expected to continue to become involved in forestry, the removal of the tax free status of woodland gains could seriously impact on the numbers of farmers becoming involved and might seriously affect the number of non-farmers investing in forestry (particularly through investment funds) resulting in a loss of benefits especially those associated with carbon sequestration. The loss of carbon credits from afforestation would seriously affect Ireland's efforts to meet its EU emission targets.

   It could also be expected that such an approach would be opposed by those who have already invested on the basis of the existing tax position who would now be liable to tax on current premium income and gains from the sale of timber. While this option would bring income into the tax net it would also allow growers to write off costs and expenses against income which they are currently unable to do. However, for non public bodies the principal cost involved (i.e. planting) is covered by a grant and therefore would not be available as a relief (Coillte does not qualify for such grants).

3. Adopt a holding strategy where by the relief would be allowed to continue for the next 3 to 5 years on the grounds that there is enough changes ongoing in the sector at present. This would allow the effects of the new Rural Development proposals and the Single Farm Payment system bed down. In addition, part of this strategy could include a commitment that the relief would

come to an end after the passing of the 3 or 5 years unless a specific decision was made to continue.

4. Scale back the relief by allowing those currently in receipt of the relief to retain it but making it unavailable for new entrants after a certain date. This would result in no immediate savings but would set a limit to the amount of future tax foregone.

   Adopting such an approach, as with the option of removing the relief altogether, could have serious implications for the number of new individuals (especially non-farmers) becoming involved in afforestation.

5. Remove the tax-free status of woodland gains but replace it with higher up-front grants and premium payments to day. An extension of the period over which the premium is paid could also be evaluated. The net effect of such a proposal would result in the net position for the grower being the same but could involve initial higher up-front cost to Government. The increased (and possible extended) payments to growers may in turn lead to a higher level of afforestation.

6. Tax forest premium income like other premium income but leave sale of final output tax free. The forestry premium is paid to compensate the farmer/grower for the loss of income from land under forestry. As such it is the same as any other income support, such as the single farm payment and an argument can be made on the basis of equity that forestry premium income should be assessable to tax on the same basis. This would result in an immediate gain to the State but might have an adverse impact on the number of individuals becoming involved in afforestation in the future.

   However, the flow of income from the sale of timber is lumpy, which results in a profit being generated in only a few years – principally the final year when clearfelling occurs- across a forty year growing cycle. It can be argued that to tax income that took forty years to mature in a single year would be unfair and that leaving this income tax free can be viewed as compensation for the time and risk undertaken by the grower.

7. Tax forestry gains at standard rate – without limit. This option would curtail the growth in the amount of tax foregone while raising an increasing amount of revenue going forward but, as with other options involving possible taxation of forestry gains, it might have an adverse impact on the number of individuals becoming involved in afforestation in the future

8. Tax premium income receipts as income in the normal way but tax the gains from clear-felling as capital gains liable at only 20%. This would have the effect of raising revenue for the State but would acknowledge that due to the long time span before gains are realised that forestry gains should receive some special treatment. As with other options involving possible taxation of forestry gains it might have an adverse impact on the number of individuals becoming involved in afforestation in the future

9. Set limits for tax free investment in Forestry funds. This would allow individuals who are non-farmers to continue to invest in afforestation but would prevent a situation arising whereby high income individuals could, in the future, use these schemes to generate tax-free income.

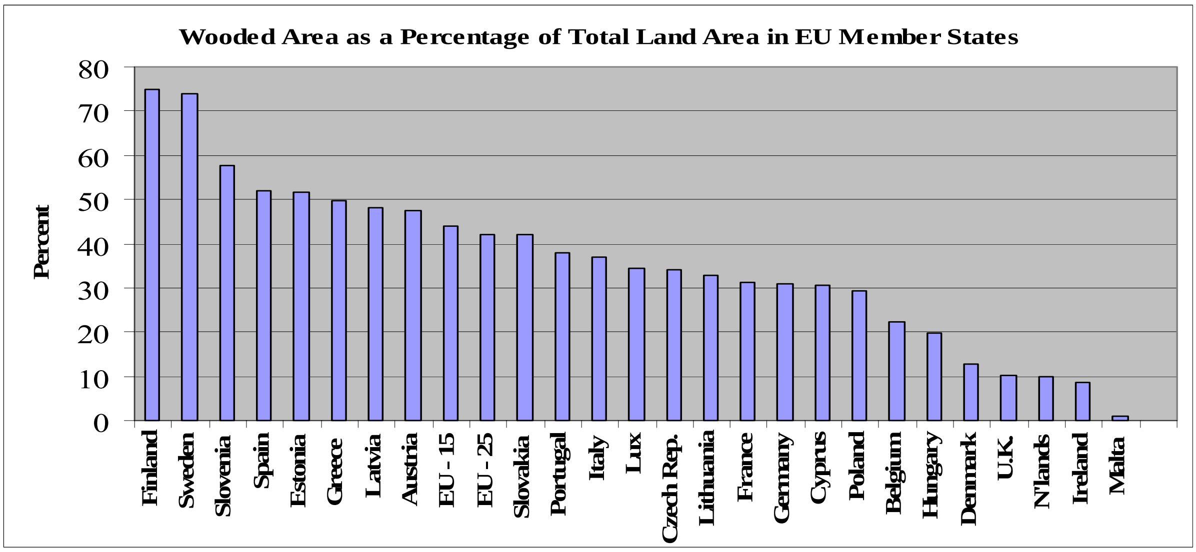
5.5 Conclusions

Deadweight associated with the relief is high but even applying this and using conservative assumptions regarding the value of benefits the outcome is very finely balanced. Both the costs and benefits can be expected to increase going forward but as the share of total output coming from the private sector is set to increase the level of deadweight can be expected to fall. This will occur because an increasing share of the output produced will have been planted in the first place in response to the favourable tax treatment of woodland gains. This will to result in the generation of overall positive economic benefits.

Therefore, while the overall result for the five years selected showed a net cost associated with the relief it can be expected that as the relative shares of output change going forward that the relief will yield positive benefits after deadweight. Given that the relief is expected to generate overall benefits in the future and that the current estimated cost is relatively low, this relief should be retained.

APPENDIX A.I
Forestry in Ireland

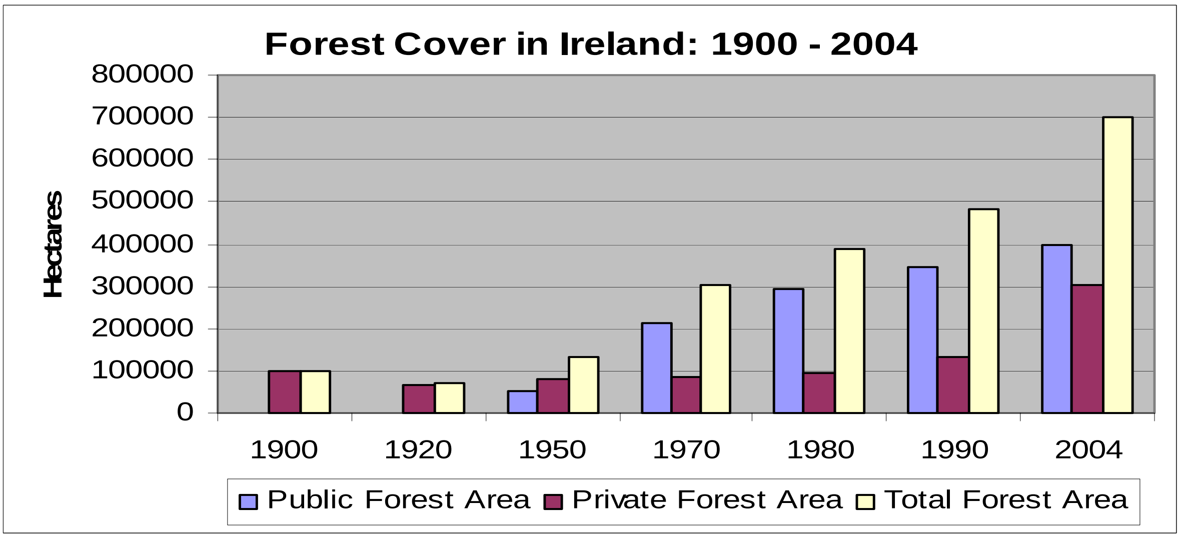
Ireland with 699,167 ha of forestry (i.e. 10% of the land area) is the second least afforested country in the European Union. Only Malta with 1% has less forest cover. Finland and Sweden at 75% and 74% respectively have the highest levels of land devoted to forestry in the EU while the EU-25 average is 42% (down from the EU-15 average of 44%).



Source: Eurostat – 2000 Figures

Afforestation in Ireland

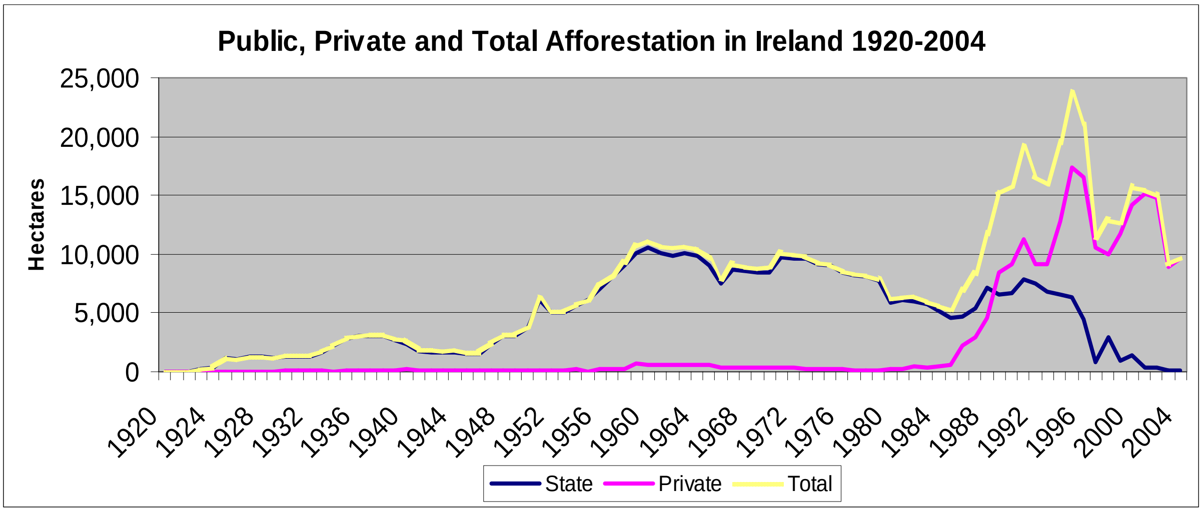
At the beginning of the Twentieth Century just 100,000 ha or 1.5% of the land area was forested of which only 300 ha were publicly owned. By 2004 the afforestation policies of successive Governments had increased the forested area to 669,167 ha, comprised of 397,611 ha (57%) of State and 301,556 ha (43%) of private forestry.



Source: Forestry Service

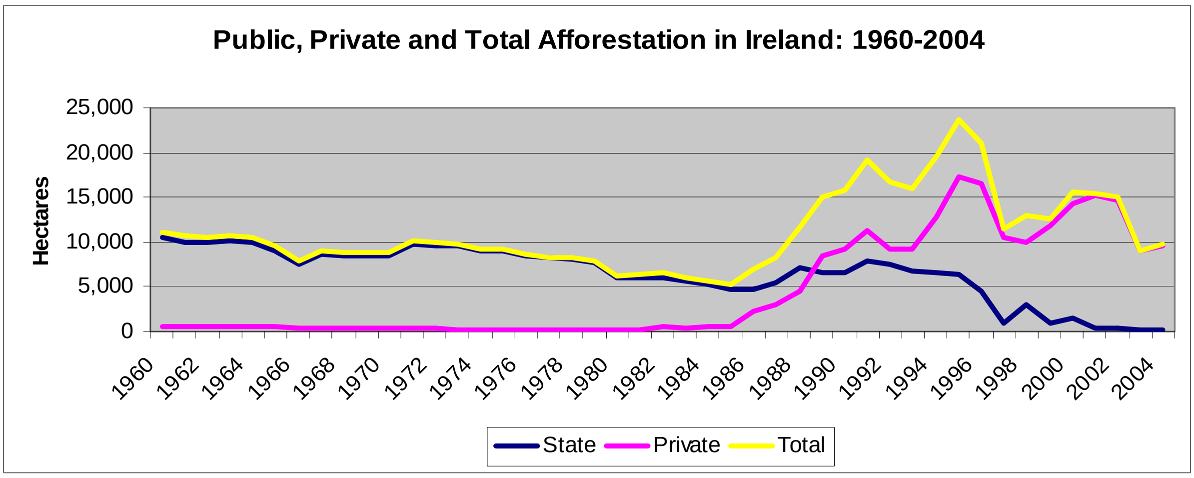
Afforestation in Ireland "constitutes the most striking land-use change that has been occurring in rural districts and is having a major impact on the Irish countryside. The current rate of afforestation in Ireland per capita is one of the highest in the world and up until recently it was characterised by an unusually high level of State participation"[48].

Afforestation activity in Ireland was dominated by the public sector up until 1989 reaching its highest annual planting total in 1960 at 10,600 ha. Private planting peaked at 17,343 ha in 1995. That year also saw the highest level of afforestation in the history of the state with 23,710 ha planted.



Source: Forestry Service

This emergence of the private sector afforestation and the decline in State planting can be seen in more detail in the chart below.

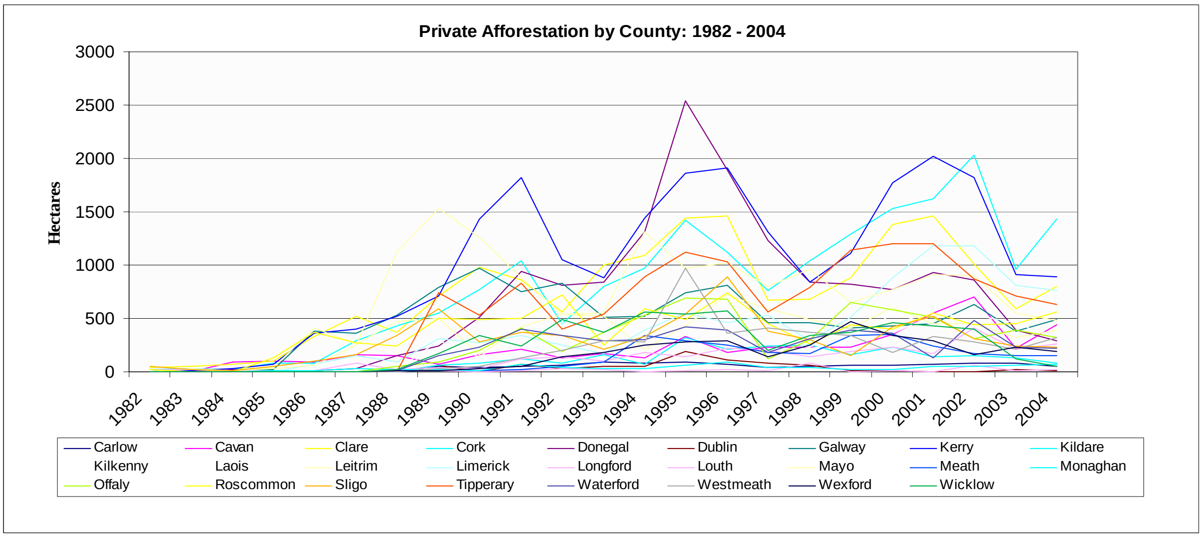


Source: Forestry Service

The following chart shows the level of private afforestation by county since 1982. While it is difficult to decipher data for individual counties for specific years it is clear that the level of private afforestation in any one year exceeded 1000 ha in only a

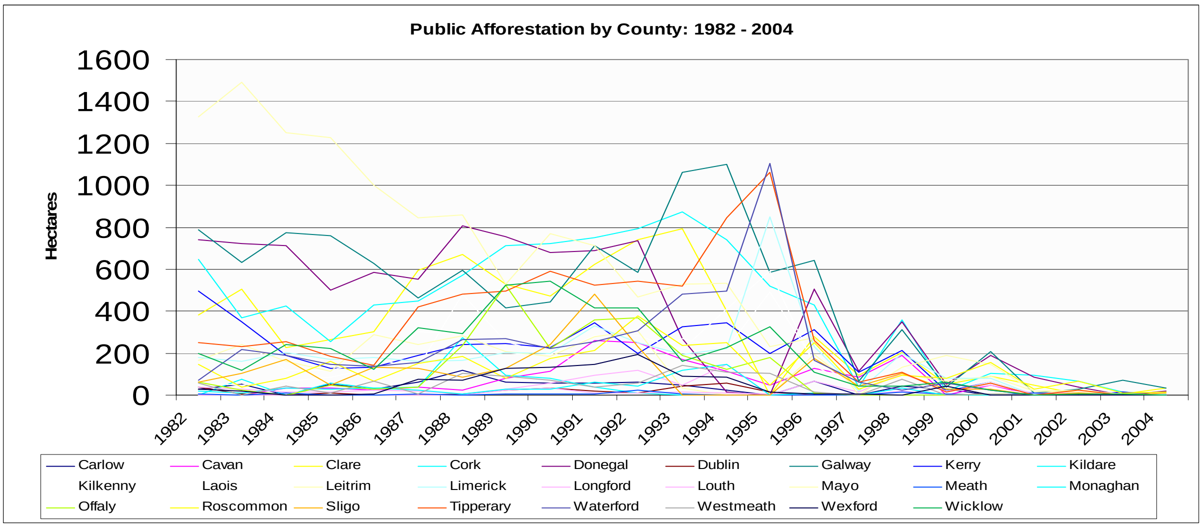
[48] Gillmore D. (1993)

few counties (Cork, Donegal, Mayo, Kerry, Limerick, Tipperary and Clare) and only in the first four has the rate ever exceed 1500 ha in a single year. Since 1982 the county with the largest percentage of total private afforestation has been Kerry at 11.6% while Louth received the least at 0.2%.



Source: Forestry Service

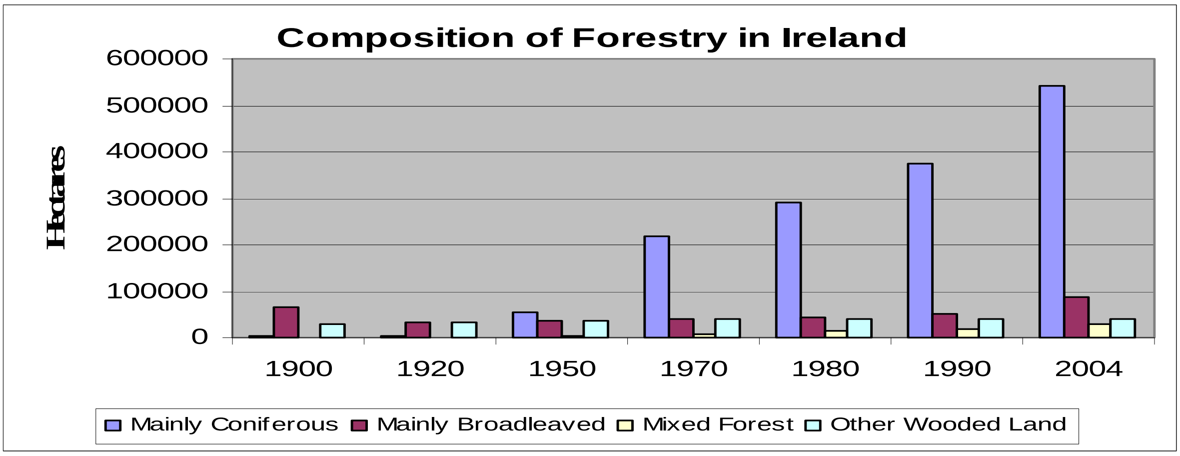
In the case of public afforestation it can be seen below that the level of planting in all counties has fallen to almost zero. Since 1982 afforestation has only exceeded 1000 ha in a single year in only four counties – Galway, Mayo, Tipperary and Waterford. Since 1982 Mayo and Galway have received the largest percentage of total state afforestation with 12.7% and 11% respectively while Meath at 0.09% received the least.



Source: Forestry Service

Composition of Forestry

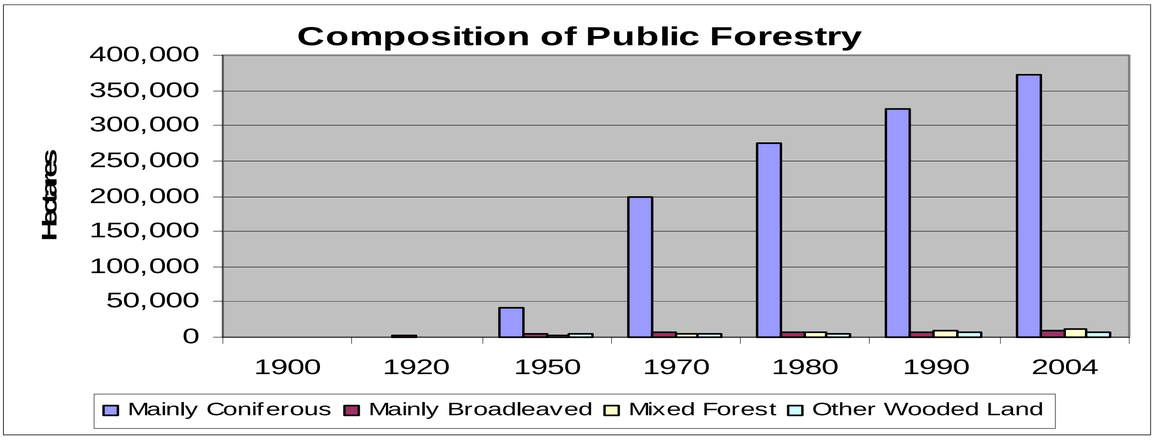
The expansion of the afforested area since the foundation of the State has been accompanied by the replacement of broadleaf varieties by coniferous trees as the dominant variety in both public and private plantations.



Source: Forestry Service

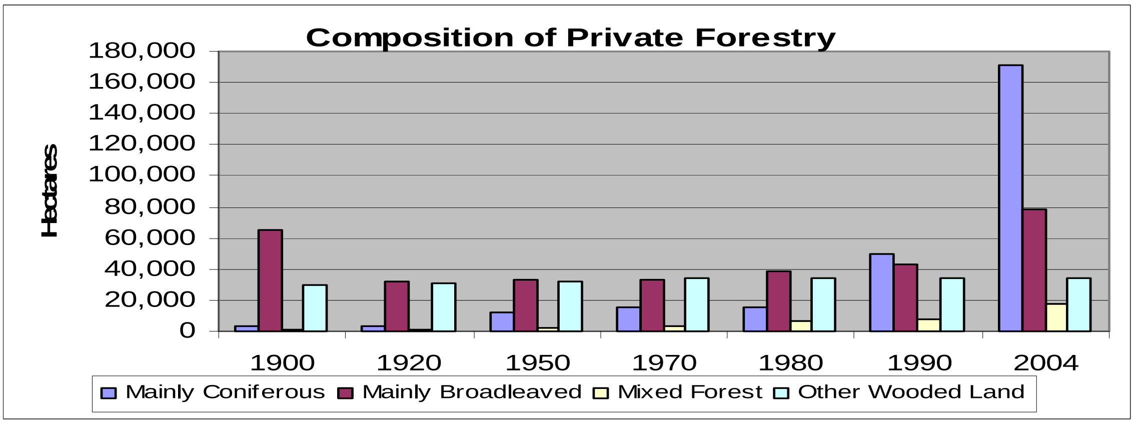
The dominance of coniferous planting in Ireland has been attributed to Ireland's temperate and moist climate combined with suitable soils which results in Irish forestry yields being the highest in Europe (treble the EU average). The mean annual growth increment of coniferous plantations is 15 cubic meters per hectare, with more than half the country being in the high yield class of 18+. In addition, Irish forests are considered relatively free from the affects of acid rain, pests and diseases and the incidence of fire damage is low[49].

While public planting was predominantly coniferous from the outset, coniferous forestry only became the dominant species in the private sector around 1990 which coincided with a massive expansion in the level of private afforestation.



Source: Forestry Service

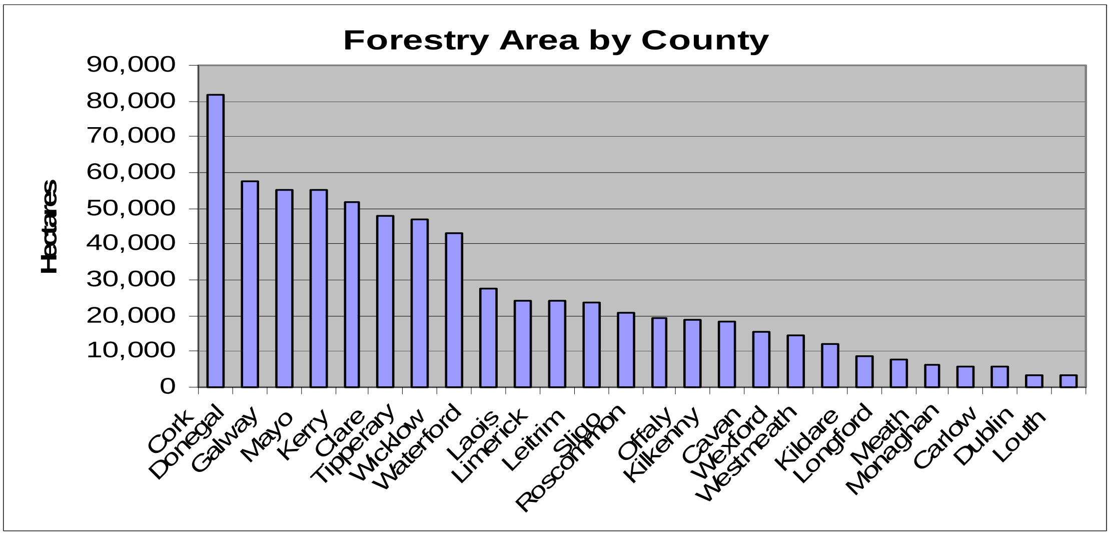
[49] Gillmore D. Afforestation in Ireland



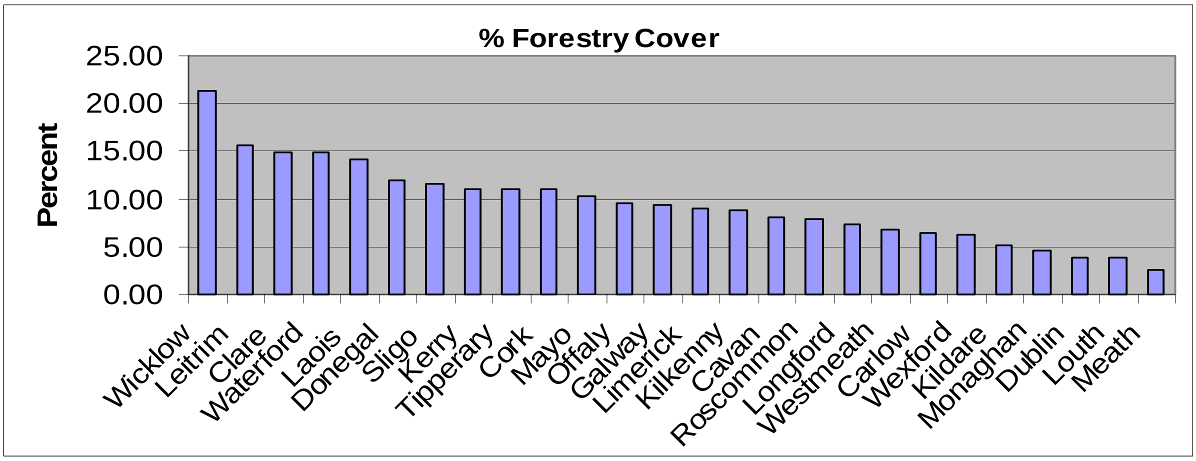
Source: Forestry Service

Distribution of Forestry

Forestry is unevenly distributed across the country with the majority located in disadvantaged areas and in counties along the western seaboard. Cork, with 81,599 ha, has the highest area under trees and Louth has the least with 3,149 ha. However, when forestry is expressed as a percentage of land area of each county, Wicklow has the highest levels of afforestation at 21% while Meath has the least at 2.66%.



Source: Forestry Service



Source: Forestry Service

Brief History of Forestry in Ireland[50]

Ireland was a predominantly wooded country up to the middle of the sixteenth century. However, the Tudor conquest and subsequent plantations resulted in the rapid felling of forests and by the early 1700s all but the least accessible forests had been cleared. Despite some afforestation by large landowners in the following 150 years the planted area of the country never exceeded 2% of the land area. The famines of the 1840s and the crop failures of the 1870s combined with the implementation of the Land Acts (which transferred land from landlord to tenant) finally ended planting on private lands and even added to the diminution of the already forested area. The net result was that Ireland entered the Twentieth Century with forest cover of just 100,000 ha or 1.5% of the land area.

Afforestation by the State in Ireland had been proposed in a Bill introduced to the British Parliament in 1884 which was unsuccessful. However, reports were commissioned on the prospects of Irish forestry which led to the first attempt at state silviculture in the British Isles. Between 1892 and 1895 the Congested Districts Board planted 200 ha of forest on peat in Knockboy, County Galway. Due to adverse site conditions and the use of inappropriate species this first attempt by the State to establish a forest plantation in Ireland failed. However, state involvement gradually expanded through the first decades of the 1900s and effective state afforestation in Ireland began ahead of that in Britain when in 1904 a Forestry Branch was formed in the Department of Agriculture and Technical Instruction. The Avondale estate in Wicklow was purchased and a forestry centre and school were established.

Due to the disruptions caused by the First World War, the War of Independence and the subsequent Civil War, the new Irish State found itself in 1922 with only c.70,000 ha of forestry (c.1% of the total land area). In 1923 c.400 ha were planted and the rate of planting was increased in the following years, reaching c.1,400 ha per annum in 1929. This rate was maintained for several years and gradually rose to 3,000 ha in 1939. The years of the Second World War saw a setback in planting and by 1945 afforestation dropped to c.1,600 ha p.a.

1948 represented a major change for Irish state forestry. A proposal was announced to increase progressively planting by the state to 10,000 ha p.a., towards a target of 400,000 ha of forest additional to that existing at the time. A key driver behind this expansion was Séan McBride T.D. who had a passionate interest in afforestation and made its expansion a condition of his participation in a coalition government in 1948, having earlier broken with the previous government party and established a new one because of its failure to adopt his forestry policy.

The 1958 Programme for Economic Expansion (and subsequent programmes) advocated ongoing support for state involvement in forestry because it was seen as having a high direct labour content and in the long run it would lead to the development of large-scale industrial conversion and processing industries to meet domestic requirements of all non-tropical forest products and secure exports of surplus production in a processed state.

[50] Based on NESC 46 and material supplied by the Forestry Service

The 1970 European Year of Nature Conservation saw the beginning of an era in which the recreation and nature conservation benefits of forests came to be appreciated. Forest parks and other recreation facilities were developed and a network of parks, walks, nature trails and picnic areas was extended throughout the country.

The environment for afforestation (especially private afforestation) altered fundamentally in the 1980s. Although this was related in part to affairs within the country the main influence was the EU. The EU commitment to forestry developed as increasing agricultural surpluses prompted efforts to divert farmland to alternative uses, with forestry having a particular attraction because of the existing and projected timber deficit at the time. The first major incentive was the 1981 Western Package Programme, a ten year programme which included substantial grant aid towards planting in twelve western counties. From 1986, annual livestock headage payments to farmers in disadvantaged areas who converted to forestry were continued for fifteen years and this measure was later succeeded by an annual forest premium payment payable to all farmers in the country. In 1988 aid under the western package was extended to disadvantaged areas in all parts of the country and the EU contribution was raised from half to two-thirds. The reform of the structural funds associated with the Single European Act provided greatly increased aid to Ireland and this afforded the opportunity for substantial EU support for Irish forestry. A five-year Forestry Operational Programme 1989-93 (Government of Ireland 1991) which provided grants up to 85% for farmers and 70% for others (within certain limits) was approved by the EU and was one-third funded by it.

In 1989 Coillte was established as a private limited company to manage State owned forests commercially and acquired ownership of the State's forests in return for shares valued at €575 million. In 2004 it reported a profit of €35 million and had a net book value of €1.27 billion.
In 1996 the Department of Agriculture, Food and Forestry drew up a Strategic Plan for the Development of the Forestry Industry in Ireland – "Growing for the Future" whose overall aim was

> *"the development of forestry to a scale and in a manner which maximises its contribution to national economic and social well-being on a sustainable basis".*

One of the principal objectives was the attainment of afforestation levels of 25,000 hectares p.a. between 1996 and 2000 and 20,000 ha p.a. to 2030 so as to increase the total productive planted area form 464,000 ha (7% of land area) to almost 1.2 million ha (17% of land area, with a consequent increase in annual timber output from 2.2 million m^3 to 10 million m^3). The strategic plan was endorsed by the Commission who acknowledged 'that implementation of the strategic plan for the Development of the Forestry Sector in Ireland requires a sustained and major programme of afforestation over the next three decades'[51].

Today forestry in Ireland faces an uncertain future. The planting targets set in 1996 have never been reached with only 9,739 ha planted in 2004 and there has been an almost total withdrawal by the state from afforestation activity, due mainly to

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[51] Foreword to Plan, by Commissioner Fischler

Coillte's ineligibility to receive EU grants. In addition, a 2005 deal struck in Luxembourg by farm ministers in relation to forestry from 2007- 2013 will see EU forestry grant rates cut from 100% to 70%, with 80% in disadvantaged areas and the term over which the premium will be paid will be cut from 20 to 15 years. While this was an improvement on the initial commission proposals which would have seen the grants cut from 100% to 40 and 50% respectively and the premium term cut to ten years it will (in the absence of alternative support measures) make forestry less attractive for the private sector. However, the introduction of the "single farm payment" as part of the CAP reforms and the ability to load premium payments on to half ones land holding may in turn encourage some farmers to consider planting part of their land.

APPENDIX A.II
Evolution of the Taxation of Gains from Woodlands[52]

The 1969 Finance Act exempted profits or gains arising from the occupation of woodlands managed on a commercial basis and with a view to the realisation of profits from income tax. Subsequent legislation either exempted or conferred favourable treatment in relation to Corporation Tax, GGT, CAT, VAT, and Stamp Duty. The following table sets out in summary format the relevant sections of legislation, their date of introduction or amendment and briefly describes the provision.

Details of extensions to Woodlands Relief: 1969 to date			
Section	**Date Introduced**	**Title**	**Description**
Section 232 TCA 1997	1969	Profits from the occupation of certain woodlands	Initial introduction of relief from income tax
Section 564 TCA 1997	1975	Woodlands	Exempted gains from the disposal of woodlands by individuals from Capital Gains Tax
Section 232 TCA 1997 Amendment	1976	Profits from the occupation of certain woodlands	Extended woodland relief to profits charged to Corporation Tax.
Section 140 TCA 1997	1976	Distributions out of profits or gains from stallion fees and occupation of certain woodlands	Extended woodland relief to disposals from corporate profits
Section 19(1) CAT Act 1976	1976	Relief for Agricultural Property	Allowed woodlands to be assessed to Capital Acquisitions Tax on the same basis as Agricultural Land
Section 17 Finance Act 1979	1979	Amendment of section 307 (right to repayment of tax by reference to losses) of Income Tax Act, 1967.	Eliminated the option of writing off woodland losses against other income.
Section 120 Finance Act 1990	1990	Exemption from stamp duty of certain instruments (commercial woodlands).	Exempted woodland from liability to Stamp Duty
Section 232 TCA 1997 Amendment	2003	Amendment of certain provisions relating to exempt income.	Required those availing of the relief from income and corporation tax to furnish a return giving details of the amount of relief being claimed

Position Prior to 1969

Up to 1969 income from land for the purpose of income taxation was measured on a notional basis and was governed by the Sections 9 and 30 of the Income Tax Act 1967, which consolidated enactments relating to income tax and sur-tax, including certain enactments relating also to corporation profit tax.

[52] Based on material from NESC 15 (The Taxation of Farming Profits) and Relevant Legislation.

Land was regarded as yielding an income from ownership, assessed under Schedule A (Section 9) and income from occupation, assessed under Schedule B (Section 31). Where the owner was also the occupier the income for income tax purposes was the total of the amounts assessed under Schedules A and B. Where the owner was not the occupier, the owner's income from the land was measured by the amount of Schedule A assessment and the occupier's income was measured by the amount of Schedule B assessment.

The amount of the notional income assessed under Schedule A was the land Valuation, under the Valuation Acts, less an allowance of one-eight, usually described as a repairs allowance. If appropriate, the interest on the land purchase annuity was also subtracted. The amount of the Schedule B assessment was either the valuation under the Valuation Acts or the annuity originally paid under the Land Acts, if any.

On average, it could be said that the notional measure of income from land under both Schedules A and B (after taking account of land purchase annuities) amounted to about one and a half times the land valuation. However, there was a statutory provision for reducing the notional assessment under Schedule B if a farmer established that the profit from occupation for any year, as measured for income tax, was less than the Schedule B assessment.

The occupier of agricultural land also had an option for any year to be assessed under Schedule D instead of under Schedule B. This meant that the income form lands could be based on the actual profits for the previous year instead of either the notional or actual profits in the current year. This allowed an occupier who had a low or nil income from land in any year to return that income for two successive years regardless of the income in the second year.

Position from 1969 Onwards

The Finance Act 1969 abolished assessments under Schedules A and B and Section 18 of that act exempted profits from commercial woodlands and from the sale of stallion services on the owner's land which were previously assessable under Schedule B, though the right to claim relief in respect of losses remained. The same section exempted farming income. As income from the occupation of woodland was exempt there was no requirement on the tax payer to take any action to avail of the relief nor was there any necessity to make any form of return to Revenue outlining details of profits or transactions on which the relief was being claimed.

Section 12 of Part 1 of Schedule 1 of the 1975 Capital Gains Tax Act (now Section 564 TCA) exempted the gain accruing on the disposal by an individual of woodlands from coverage by the Act but this exemption did not extend to corporate owners of woodland.

Section 11 (6) of the Corporation Tax act 1976 (now Section 232 TCA) extended the income tax exemption on gains from woodland gains to corporation tax while Section 93 of the same Act (now Section 140 TCA) extended the exemption to cover distributions made from exempted corporate profits.

In the same year Section 19 (1) of the Capital Acquisition Tax Act 1976, relieved woodlands, for CAT purposes, on the same basis as agricultural land.

Section 17 of the Finance Act 1979 closed off a loophole whereby losses incurred in woodland activity could be written off against all other income and Section 120 of the Finance Act 1990 relieved timber in commercial woodlands from Stamp Duty but the value of the underlying land remained liable.

As taxpayers were not required to include income arising from qualifying woodlands in their tax returns, there was no basis on which to provide an estimate of the cost to the Exchequer of these tax exemptions. Section 35 of the Finance Act 2003 moved to remedy this situation by requiring companies and individuals availing of this relief to furnish returns detailing the amount of income upon which they were claiming the relief.

APPENDIX A.III
Government Afforestation Policy

Ireland was once covered with forests but these were steadily and systematically cleared during the closing centuries of the last millennium. By 1910 only 1% of the country remained under forest cover. Therefore, afforestation in Ireland has been supported as a policy even prior to the foundation of the state. Current Government forestry policy has as its overall aim,

"the development of forestry to a scale and in a manner which maximises its contribution to national economic and social well-being on a sustainable basis"[53],

and one of the principal objectives is the attainment of afforestation levels of 25,000 hectares p.a. between 1996 and 2000 and 20,000 ha p.a. to 2030 so as to increase the total productive planted area form 464,000 ha (7% of land area) to almost 1.2 million ha (17% of land area, with a consequent increase in annual timber output from 2.2 million m^3 to 10 million m^3).

The reasons for Government support for tree planting are varied and have changed over time. Speaking at the introduction of the second stage of the 1928 Forestry Bill, Senator O'Hanlon summed up the advantages of trees as

"making the country more beautiful and also more healthy and attractive. They protect the surface soil from erosion, and as well they form areas of forest floor which absorb large quantities of water, preventing floods and acting as catchment areas for reservoirs and springs. Trees supply employment for a portion of the rural population, and they supply the necessary timber for which huge sums are paid out every year to foreign countries. Trees form a shelter for farm stock, prevent extreme heat and cold, and provide the raw material for industries which follow in their train".

For a long time the most specifically stated and apparently prime objective was national self-sufficiency in timber supply. However, a reading of the Dáil Debates would suggest that the main reason for the support of State planting and grants for private afforestation was the belief that planting trees would supply employment rural areas. There has always been recognition of the employment benefit of afforestation but the relative emphasis on commercial and social objectives have varied and there has been a tension between the two especially as the State attempted to manage its woodlands on a commercial basis. Speaking in a Finance Committee debate on forestry in 1929[54] Dr Ryan stated that:

"Afforestation, apart from supplying our needs in timber, which is rather a big item, amounting to a million and a half pounds worth imported last year, is one of the most useful forms of industry for absorbing the unemployed in rural areas".

These views were echoed in 1952 by Mr. Palmer who said that

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[53] The Strategic Plan for the Development of the Forestry Industry in Ireland – "Growing for the Future" - Dept of Agriculture, Food and Forestry – 1996
[54] Dáil Éireann - Volume 30 - 26 June, 1929

“The salvation of the western seaboard and the Gaeltacht areas depends on the extent to which forestry can be developed in those districts[55]”,

and by Mr. MacBride, who while speaking in a debate on the unemployment situation also in 1952 said that;

“One particular sphere in which public works could be extended…and which would absorb a considerable proportion of the rural unemployed, particularly in areas west of the Shannon, is the rapid expansion of forestry … it is one of the public works which has the greatest amount of labour content in proportion to the expenditure on it[56]”.

The 1958 Programme for economic expansion (and subsequent programmes) saw the long term aims of economic policy in relation to forestry as including the development of large-scale industrial conversion and processing of timber to meet in full domestic requirements of all non-tropical forest products and to secure exports of surplus production in a processed state. However, while the programmes provided some guidance in relation to policy for afforestation going forward they did not provide any justification for state involvement as the principal agent of planting with the private sector seen only as a supplement.

By the 1970s the programmes for economic expansion were discontinued but policy of state afforestation continued subject to budgetary constraints. The exemption on gains from commercial woodland, introduced in 1969 was extended to corporate profits and a number of other favourable tax treatments for forestry gains were introduced. However, a prime objective which permeated afforestation policy until the 1980s was that competition with agriculture, especially for land should be minimised. Assessments of comparative profitability with agricultures indicate a substantial relative attractiveness of forestry on low quality land, especially on wet mineral soils. Thus the policy of not using land that might be considered suitable for agriculture was not based on productivity criteria but was to protect the interests of farming and avoid conflict for social and political reasons. This was implemented through the financial control of adherence to low land acquisition prices and the institutional regulator of consultation between the forest service and the Land Commission, which was the body responsible for agrarian structure.

In 1982, C.J. Haughey, as Taoiseach launched The Way Forward – National Economic Plan 1983-1987. This plan stated that “Forestry constitutes a significant natural resource with both national and regional potential….Over the period of the Plan and beyond, this investment (in forestry) will provide substantial opportunities for development and for substituting domestic timber for imported wood and wood products”. In the plan the Government committed to maintaining the state planting programme at an average annual level of 7,500 ha p.a. with a longer term aim of 10,000 ha p.a. and encouraging private forestry with the aid of grants and technical

[55] Dáil Éireann - Volume 133 - 02 July, 1952

[56] Dáil Éireann - Volume 133 - 02 July, 1952

advice with a view to enabling the private sector to make a more significant contribution to the overall national afforestation programme.

The 1985 National Plan “Building on Reality” introduced by the new Government stated that it was their intention to ensure that the nation’s forests be developed to the maximum national advantage and that the overriding objective in the exploitation of the State-owned natural resources should be the maximisation of the benefit accruing to the State on behalf of the community. They set up a Review Group on Forestry to develop a strategy for the sector going forward. This Group considered that the fundamental aim of the strategy should be the creation of wealth. They accepted that greater attention should be accorded to environmental consideration, wildlife habitat, recreational facilities and perhaps the impact on tourism but stated that these are not the immediate concern of an enterprise charged with the commercial exploitation of Ireland’s wood resource.

In 1987 the Programme for National Recovery 1987 – 1990, adopted an action programme to realise the potential for job creation, import substitution, export revenue, regional and social development that exists in forestry. It was during this period that Coillte was established as commercial State sponsored body charged with the future development of Ireland’s forestry resources. The availability of EU money to support afforestation led to the drawing up in 1989 of the Forestry Operational Programme which had as its prime objective

“to contribute to the generation of wealth in the Irish economy by utilising available and suitable land and human and financial resources, to the best advantage in creating new and developing existing forests so as to: provide the raw material base for an expanded and improved forestry-based industrial sector; diversify the rural economy; stimulate rural development; provide employment; and promote the reform of agriculture structure”.

The making of a positive contribution to the environment by afforestation was not included in the objectives of this Programme but was added as an objective in the preface by the Minister.

The subsequent Programme for Economic and Social Progress – Programme for the nineties – Planned to expand national planting to 30,000 ha p.a. by 1993 and to be maintained at that level to 2000 – through a combination of public and private planting. It also planned to create 1,890 extra jobs by 1993 with a further 1,200 over the period 1994 – 2000, to encourage further investment by pension funds in forestry and to ensure that all forestry works undertaken contribute to the improvement of the environment, particularly by increasing the emphasis on broadleaved species and applying strict guidelines to protest areas of scientific interest, landscapes and fishery catchments.

This policy was continued in the Programme for Competitiveness and Work – 1994 – 1996 which said that “tree growing in Ireland has a competitive advantage and forestry can make a significant contribution to job creation, the improvement of farmers’ incomes and rural development”. Objectives of the plan included maintaining the planting target of 30,000 ha p.a., to create a minimum of 1,500 jobs during the programme and to undertake a review which would result in a long-term plan for the sector aimed at maximising the value of the forestry sector to the economy and at integrating forestry development into wider rural development policy. This review led to the publication in 1996 of the Strategic Plan for the Development of the Forestry Industry in Ireland – "Growing for the Future" which is still the basis for Government forestry policy.

Partnership 2000, the Programme for Prosperity and Fairness 2000 – 2003 and Sustaining Progress – 2003 – 2006 maintained policy as set down in the 1996 Strategy which was "To develop forestry to a scale and in a manner which maximises its contribution to national economic and social well-being on a sustainable basis and which is compatible with the protection of the environment and supportive of climate change commitments". Sustaining Progress also noted that forestry will play a key role in facilitating achievement of Ireland's commitments under the Kyoto Protocol a fact which is clearly identified in the Government's *National Climate Change Strategy*.

APPENDIX A.IV
Grants & Premia

While the purpose of this study is to examine the costs and benefits associated with the woodland tax relief this appendix briefly examine the support given to afforestation by Government in the form of grants and premia in addition to tax relief (details of the current levels of grants and premia available are provided in Tables 1 and 2 at the end of this appendix). Research has indicated that it is these supports and not the tax concession which have been responsible for the major expansion in private afforestation in Ireland[57]. Indeed it is contended by some researchers that the tax concession have had no measurable effect on the level of afforestation[58].

The State, as well as being directly involved in planting (initially through the Forestry Service and currently through the commercial State Sponsored Body, Coillte), has since 1928, provided grants to encourage the private planting. These grant schemes now receive European Funding as part of the accompanying measures to CAP reform and support for Rural Development and are accompanied by forest premium payments to compensate farmers and non-farmers for the loss of income earning potential from the afforestation of their land.

Grant and Premium Payments: 1930 - 2004				
	Min Grant	**Max Grant**	**Min Premium**	**Max Premium**
	€ per Hect	**€ per Hect**	**€ per Hect**	**€ per Hect**
1930-1945	13	13		
1946-1958	31	31		
1959-1971	63	63		
1972-1977	110	110		
1978-1979	282	282		
1980	392	392		
1981-1987	392	1016		
1988	635	1016		
1989-1992	1143	2539	63.49	198.08
1993-1997	1651	3809	101.58	380.92
1998-1999	1955	5079	114.28	431.71
2000-	2730	6730	171.41	473.61

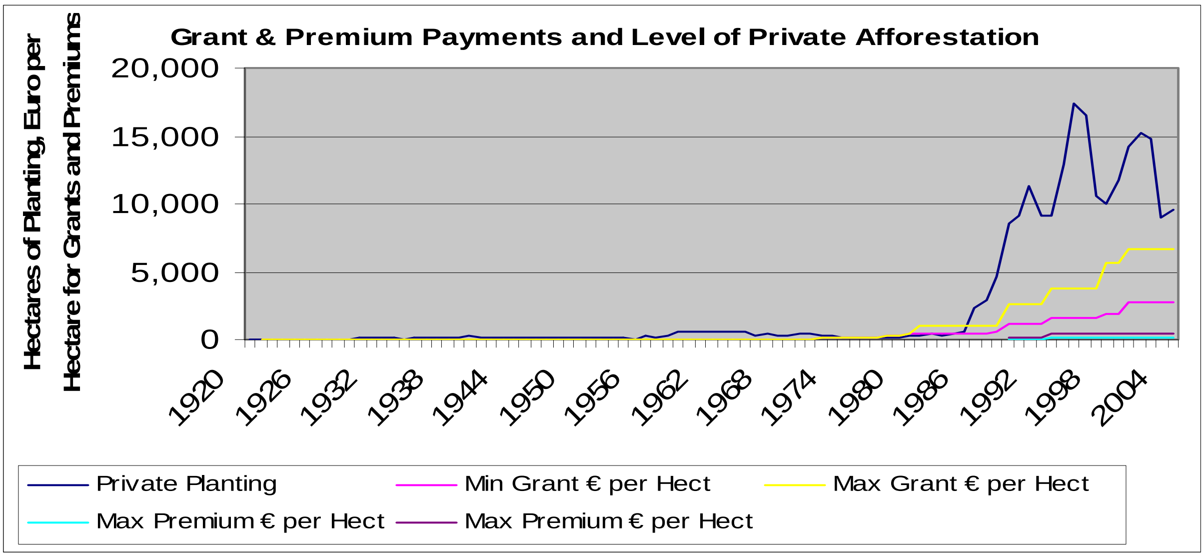
Source: Forestry Service, Dáil Records 1928-2004

The principle of providing state grants towards private forestry was adopted in 1928 but the response to the incentive was slight exceeding 100 ha nationally in only one year during the 1930's. A campaign to promote private afforestation initiated in 1958 under E. Childers as minister led to a significant but short lived response, with annual planting falling from a peak of 530 ha in 1962. The promotion had included doubling the state grant, provision of free technical advice and extensive publicity. The level of planting had fallen to 130 ha by 1979 and the total extent of grant-aided private planting from 1929 did not exceed 10,000 ha until 1981 (i.e. 3.4% of the area planted by the state in the same time period).

This chart below traces the level of grant against level of private afforestation. It can be seen that planting only takes off when the grants begin to increase significantly. In

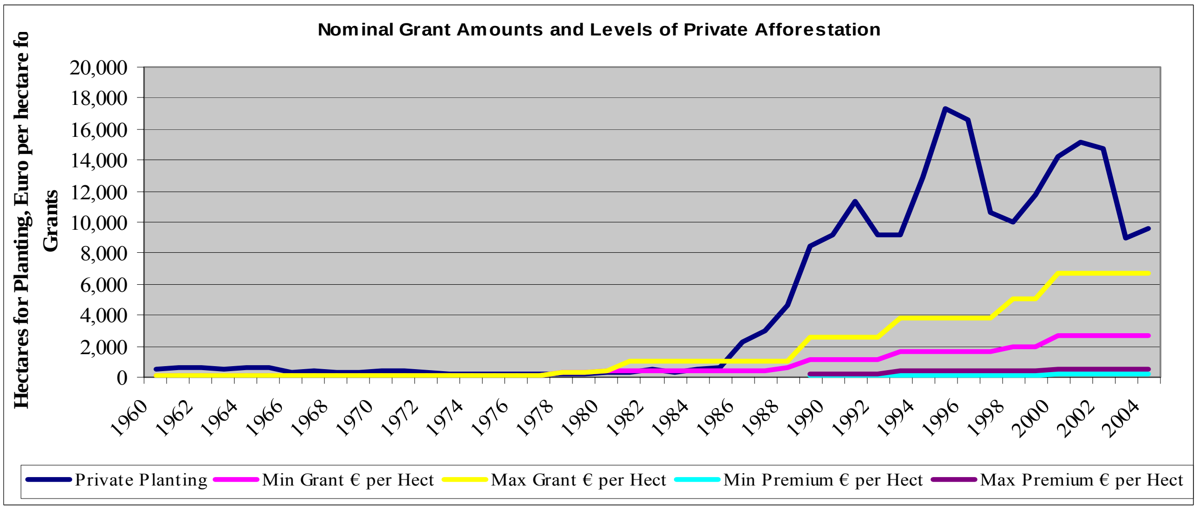
[57] McCarthy et al, Kulla
[58] McCarthy, Kulla

addition, it can be seen that there was no response in level of private planting in 1969 when tax relief introduced or indeed in 1975 or 1976 when it was extended.



Source: Forestry Service, Dáil Records 1928-2004

These following charts contain the same information as above but focus on the period since 1960 and shows in more detail that the rise in the level of afforestation coincided with the increase in the level of grant in nominal and inflation adjusted terms.



Source: Forestry Service, Dáil Records 1928-2004

The chart below shows that this link is more clearly seen when the grant amounts are adjusted for inflation.

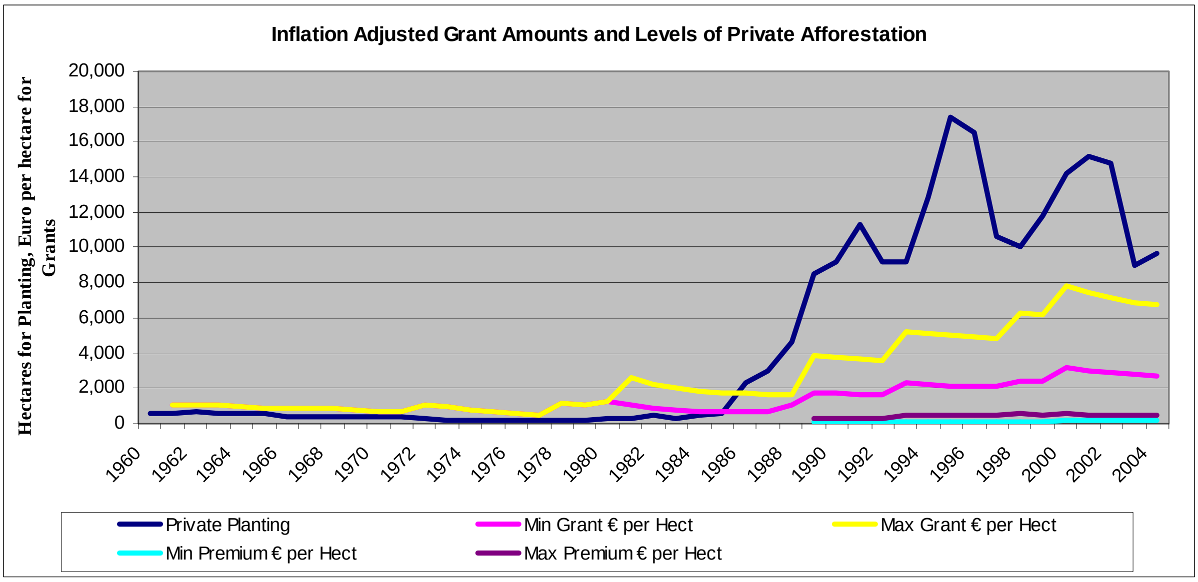


TABLE 1: SCHEDULE OF GRANT RATES

	AFFORESTATION GRANT £/PER HA	SECOND INSTALMENT GRANT £/PER HA	TOTAL GRANT £/PER HA
UNENCLOSED LAND	1,600	550	2,150
ENCLOSED LAND/ IMPROVED LAND			
• Sitka Spruce Lodgepole Pine	1,600	550	2,150
• 20% Diverse	1,700	550	2,250
• Diverse	1,900	600	2,500
BROADLEAF • Approved Species other than oak/beech. 100% stocking	3,000	900	3,900
OAK • 75% - 100% stocking	3,800	1,200	5,000
BEECH • 80% - 100% stocking	4,000	1,300	5,300

The afforestation grant is cost based up to the maximum grant level shown. In the interests of multi-functional forestry objectives, broadleaved rates of aid may be extended to unenclosed land on a case by case basis.

Source: Forestry Service

TABLE 2: RATES OF PREMIUM PAYABLE

NEW PREMIUM RATES "FARMERS"

Land Category			Premium Rate £/ha
Unenclosed Land			165
Enclosed Land/ Improved Land	Conifers	non diverse	265
		20% diverse	308
		diverse	328
	Broadleaves	ash/syc	348
		oak/beech	373
			£/ha
"Non Farmers"	Conifers		135
	Broadleaves		145

In addition, in respect of new planting grants a supplement of £10/hectare will be payable on sites greater than 6 hectares and £20/hectare on sites greater than 12 hectares in respect of sites planted by farmers on enclosed land. In the interests of multi-functional forestry objectives, broadleaved rates of aid may be extended to unenclosed land on a case by case basis.

Source: Forestry Service

APPENDIX A.V
State Aids and Forestry

The Treaties on European Union make no provisions for a comprehensive common forestry policy. The position regarding forest products such as wood, cork and resins is that the rules of the Internal Market, including the normal EU competition rules on State aid, apply. However, there are no specific State aid guidelines for aid to the forestry sector. The Commission has, however, traditionally followed a favourable approach to forestry measures because of the social benefits, the positive ecological benefits and the valorisation of forests and forest products generated by such measures. Accordingly, it is established Commission practice in this field to consider State aid of up to 100 per cent of costs for the preservation, improvement, development and maintenance of forests.

The rural development policy has been the main instrument for the implementation of the EU Forestry Strategy at Community level. From a review of a number of State aid decisions by the Commission in the forestry sector it appears that the Commission follow the principles that apply to State aid to the agriculture sector and in some cases to aid that is permitted under other State aid frameworks such as aid for research and development and the Commission's regulations on *de minimis* aid. (See state aid decision NN88/A/2002).

This relief is a pre-accession relief and was therefore not subject to the notification requirement of post accession aid schemes. It was however included in a number of annual returns of State aid measures in the agriculture sector submitted to the Commission in the 1980s.

The Commission is currently reviewing its policies on State aid to the forestry sector and in approving recent forestry measures has indicated that it reserves the right to propose appropriate changes to the measures under Article 88(1) of the Treaty in due course. Article 88(1) empowers the Commission to review all existing State aid and make proposals to amend or terminate such aid if the Commission finds such aid to be incompatible with the progressive development or the functioning of the common market. Therefore, the Commission can at any stage in the future request that this relief be terminated or altered to a significant degree.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section B:

Tax Relief for Donations to Charities and Approved Bodies, including Sports Bodies – Sections 847A and 848A of the Taxes Consolidation Act 1997

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1. Executive Summary

1.1 The Minister for Finance, Brian Cowen, T.D., announced in his Budget Statement on 1 December 2004 that the Department of Finance and the Office of the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and exemptions during the course of 2005, with a view to informing the development of the 2006 Budget and Finance Bill.

1.2 The idea of a tax incentive is to encourage people to invest financial resources in a tax efficient manner for certain socio-economic objectives. The purpose of this review of certain tax incentive schemes and exemptions is to evaluate the impact and operation of such schemes including their economic and social benefits for the different locations and sectors involved and to the wider community. In addition the review will examine the degree to which these schemes allow high-income individuals to reduce their tax liabilities.

1.3 The tax relief for donations to charities and approved bodies, including sports bodies was included in the list of reliefs to be reviewed. This is a report of this review. It has been prepared by the Department of Finance in consultation with the Office of the Revenue Commissioners. The report describes the relief, explains the policy behind its introduction and sets out the known costs and benefits of the scheme along with an evaluation of the workings of the relief. The report also considers the options for changing and improving the scheme.

1.4 Section 848A of the Taxes Consolidation Act, 1997 provides for a scheme of tax relief for certain charities and other approved bodies, including first and second level schools and third level institutions, in respect of donations received on or after 6 April 2001. In order to qualify for the relief, the minimum donation made to any one eligible charity or approved body in a year is €250. The donation must not confer any benefit on the donor or any person connected with the donor. Where there is no association between the donor and the charity/approved body to which the donation is made, there is no maximum qualifying donation. Where a donation is made by an individual to a charity or approved body with which he/she is associated, a maximum of 10% of the individual's total income can attract tax relief. For a PAYE taxpayer, the relief is given on a grossed-up basis to the body. Individuals who are self-assessed and companies claim the relief by deducting the donation as if it was a trading expense.

1.5 Section 847A was introduced in Finance Act 2002. It allows tax relief for donations to approved sports bodies for the funding of approved capital projects. The arrangements for allowing tax relief for donations are similar to those for Section 848A.

1.6 Two objectives can be identified for these reliefs – they encourage individuals and companies to donate to charity and approved bodies, including churches, religious orders and sports bodies, and they allow donors to exercise choice with regard to which bodies benefit from Exchequer support.

Section 848A

1.7 The works carried out by charities and approved bodies are in many ways ‘collective’ in their benefit, in that they may confer a benefit to society over and above the benefits that the recipient or supplier may get from the arrangement, and as a consequence such works tend to be under-supplied. These benefits are often also intangible, that is they are typically not found in the market place. For this reason, it is difficult to determine and place a monetary value on the benefits arising from this tax relief scheme.

1.8 The cost of this scheme is likely to rise as organisations become more aware of the scheme and they in turn inform their donors and encourage them to give in a tax efficient way. The charity sector has welcomed the scheme, noting that a wide range of sectors are benefiting.

1.9 In 2001, it was estimated that the cost to the Exchequer for this relief would be €10m in 2001 and €29m in a full year. In 2004, €14.8 million was refunded by Revenue to charities and other approved bodies in respect of claims arising for donations made by PAYE taxpayers. Of this, 65.5% went to the religious sector, 6.1% to community organisations, 19.6% to the relief of poverty and 8.8% to approved bodies.

1.10 In 2002, the cost of the tax foregone arising from the relief to the self-assessed sector was €5.1 million. A review of the tax files of individuals with high incomes by Revenue indicates that in that year, 63 of the top 400 individuals with high incomes claimed tax relief on donations of €5.4m under Section 848A, and hence the tax forgone from these taxpayers through their use of this scheme is in the order of €2.4m. While these donors account for a significant proportion of the overall relief claimed, this is in keeping with the original aim of encouraging those with significant incomes to donate to charities and other bodies.

1.11 Due to the way companies claim this relief, their tax returns to Revenue do not allow for the costing of the relief to them. Accordingly, the Department of Finance carried out a survey of companies. The returns to this survey indicated that many companies do not give significantly to eligible charities and other approved bodies and when they do, tax relief is not the incentive. Responses also indicate that there is a high degree of deadweight in the scheme, with the majority stating that the relief had not led them to increase the amount they donate.

Section 847A

1.12 It is difficult to put a value on the benefits arising to sports bodies and ultimately the wider community from the existence of such a relief. Section 847A is only a small part of overall State support for the sporting sector.

1.13 While it is still early days for the scheme, the number, value and variety of projects approved by the Department of Arts, Sports and Tourism is increasing over time. At the end of September 2005, 129 clubs had been approved for projects to the value of €127 million. Clubs have reported to the Department of Arts, Sports and Tourism that they had received €9 million in donations by the end of 2004.

1.14 When this scheme was introduced, it was estimated that it would cost €0.7 million in 2002 and €7m in a full year. The latest statistical data available is for 2002. In that year, Revenue refunded €0.05 million to approved sports bodies in respect of donations from PAYE taxpayers and they estimate that the tax foregone due to donations from self-assessed taxpayers was of the value of €0.07 million.

1.15 In the Department of Finance survey of companies, two out of fifty-three respondents gave money to sports bodies under Section 847A.

Recommendations

1.16 The structures of the schemes should be retained as they are. Organisations are still working to make their donors aware of the existence of the schemes and time should be allowed for the structures as they exists to become established. This includes retaining the €250 threshold, the current ways of treating PAYE and self-assessed donors and the requirement that charities have tax exemption status for two years to become eligible for the scheme.

1.17 Efforts should be made to improve the data collection for these schemes so information is available with regard to the overall cost of scheme and by category of taxpayer - PAYE, self-assessed and corporate. Information is also needed on what groups are benefiting from the donations and how much is being donated by each category of taxpayer.

1.18 The relief should not be extended to non-cash items as no tax charge arises on the donation of an asset to a charity. In addition, it would be difficult for Revenue to value these assets.

1.19 There should be continued vigilance on the part of Revenue to ensure the schemes are not abused and that no benefit is conferred on the donor as a result of his/her donation.

1.20 Charities and approved bodies should promote the scheme more widely. Increased awareness of the scheme should lead to them receiving greater donations.

2. Introduction

2.1 The Minister for Finance, Brian Cowen, T.D., announced in his Budget Statement on 1 December 2004 that the Department of Finance and the Office of the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and exemptions during the course of 2005, with a view to informing the development of the 2006 Budget and Finance Bill.

2.2 The idea of a tax incentive is to encourage people to invest financial resources in a tax efficient manner for certain socio-economic objectives. The purpose of this review of certain tax incentive schemes and exemptions is to evaluate the impact and operation of such schemes including their economic and social benefits for the different locations and sectors involved and to the wider community. In addition the review will examine the degree to which these schemes allow high-income individuals to reduce their tax liabilities.

2.3 The tax relief for donations to charities and approved bodies, including sports bodies was included in the list of reliefs to be reviewed. This is a report of this review. It has been prepared by the Department of Finance in consultation with the Office of the Revenue Commissioners. The report describes the relief, explains the policy behind its introduction and sets out the known costs and benefits of the scheme along with an evaluation of the workings of the relief. The report also considers the options for changing and improving the scheme.

3. Scheme of Tax Relief for Donations to Eligible Charities and other Approved Bodies, Section 848A, Taxes Consolidation Act 1997

Background

Description of Scheme

3.1 Section 848A of the Taxes Consolidation Act 1997 provides for a scheme of tax relief for certain charities and other approved bodies, including first and second level schools and third level institutions, in respect of donations received on or after 6 April 2001. In order to qualify for the relief, the minimum donation made to any one eligible charity or approved body in a year is €250. A charity must have charitable status approved by the Revenue Commissioners for at least two years in order to qualify under the scheme. The donation must not confer any benefit on the donor or any person connected with the donor. Where there is no association between the donor and the charity/approved body to which the donation is made, there is no maximum qualifying donation. Where a donation is made by an individual to a charity or approved body with which he/she is associated, a maximum of 10% of the individual's total income can attract tax relief.[59]

3.2 The arrangements for allowing tax relief on donations depend on whether the donor is a PAYE taxpayer or an individual on self-assessment or a company. For a PAYE taxpayer, the relief is given on a grossed-up basis to the body. In the case of a donation made by an individual who is self-assessed, the individual claims the relief and there is no grossing-up arrangement. Similarly, in the case of companies, the company claims a deduction for a donation as if it were a trading expense. The practical ability to avail of the tax relief is dependent on having taxable income against which to offset the relief.

3.3 Two objectives can be identified for this relief – it encourages individuals and companies to donate to charity and approved bodies and it allows donors to exercise choice with regard to which bodies benefit from Exchequer support (see Appendix 1). Speaking in the Dáil in 2001 when introducing the scheme, the then Minister for Finance, Mr. Charlie McCreevy, said -

> "Section 41 [of Finance Bill 2001] introduces a new uniform tax relief scheme for donations. This will involve merging almost all existing reliefs. The new relief will be available at a taxpayer's marginal rate of tax for both personal and corporate donations. The minimum donation which can attract relief will be £250 [€317]. There will be no upper limit on the total amount of relief afforded to individuals or companies. The relief will be available for donations to all beneficiaries under the existing schemes which are being merged, including those for Third World charities. It will apply to donations to all charities which have tax exempt status for three years and to first and second level schools and third level institutions. This represents a major expansion in the relief, for example, for personal donations to domestic charities and educational establishments. I am very aware of the enormous sound contribution made by charitable donations in the United States, triggered by their tax relief

[59] For further details see - Revenue Commissioners, *Scheme of Tax Relief for Donations to Eligible Charities and other Approved Bodies, under Section 848A, Taxes Consolidation Act 1997*, www.revenue.ie/leaflets/chy2.doc

arrangements. We have a tradition of voluntary effort and charitable donations in Ireland and this should be encouraged. For ease of administration, it is envisaged that the tax relief for most taxpayers will be paid by Revenue to the body receiving the donations rather than paid to the donor. Individuals on self-assessment will claim the relief and companies will make the deductions as if the donation were a trading expense."[60]

3.4 The then Minister for Finance further told the Select Committee on Finance and the Public Service that experience had shown with previous tax relief schemes that -

> "in the last month before 5 April people would run into every accountants' office in the country looking for schemes in which to put their money rather than pay tax. When people get something back or when their tax bill is lowered, they feel they are getting something. People are best qualified to decide whether they would like to look after a school or a charity in their area. If a person has made a few quid from his business, why not encourage him, through the tax system, to donate money?...I believe people, especially business people, will be more inclined to support charitable causes, say at their local school, if their contributions are allowed as a deductible trading expenditure in their accounts. I would have liked to apply the same logic to those on PAYE, but administratively it is far easier to use the system devised by my predecessor Deputy Quinn, in respect of Third World charities, where the net amount is paid and at the end of the year the Revenue Commissioners pay the relevant charity."[61]

3.5 Section 848A came about after Mr. McCreevy stated in his 2001 Budget speech that he would "examine before the Finance Bill the myriad of tax reliefs for donations of various types to different causes to see if we can come up with a more sensible and coherent system to encourage gifts for genuinely good causes".[62] The system as it existed involved eleven tax reliefs for donations to various causes with marked differences between the provisions; with some having de minimis limits, some having maximum limits, some being granted at the standard rate while others were at the marginal rate. The eleven provisions amalgamated into the new scheme were –

i. Section 88 – Deduction for gifts to Enterprise Trust Ltd
ii. Section 484 – Relief for gifts for education in the arts
iii. Section 485 - Relief for gifts to third-level institutions
iv. Section 485A – Relief for gifts made to designated schools
v. Section 485B – Relief to gifts to the Scientific and Technological Education (Investment) Fund
vi. Section 486 – Corporation tax – relief for gifts to First Step
vii. Section 486A – Corporate donations to eligible charities
viii. Section 764 – Deduction for revenue expenditure on scientific research

[60] Dáil Éireann - Volume 531, Column 592 - Finance Bill, 2001: Second Stage, 27 February 2001.
[61] Minister for Finance to Select Committee on Finance and the Public Service, 7 March 2001.
[62] Financial Statement of the Minister for Finance, 6 December 2000, www.finance.gov.ie.

ix. Section 767 – Payments to universities and other approved bodies for research in, or teaching of, approved subjects
x. Section 848 – Designated charities: repayment of tax in respect of donations
xi. Section 792 – Income under dispositions for short periods

Section 848A was loosely based on Section 848. This had been introduced in Budget 1995 and allowed for tax relief on donations ranging from £200 (€254) to £750 (€952) to designated Third World Charities at the standard rate of income tax and the receiving charity received the tax associated with the contribution from the Revenue Commissioners. The then Minister for Finance, Mr. Ruairi Quinn, explained that -

> "this new measure will, for the first time, allow people to exercise choice with regard to the agency to which they wish the State to contribute part of our Official Development Assistance."[63]

3.6 Initially the minimum qualifying donation proposed for Section 848A was £250 (€317) but following a proposal made at the Select Committee on Finance and the Public Service the Minister for Finance agreed to bring forward an amendment to reduce it to £200 (€254).[64] At first there was no maximum qualifying donation but Finance Act 2003 inserted a maximum limit on the amount of donation that can attract relief where the donation is made by an individual to a charity or approved body with which he/she is associated. In such a case, where the aggregate of donations to any one charity or approved body in a year is in excess of 10% of the individual's total income, the excess does not attract tax relief. The reason for this change was explained by the then Minister for Finance, Mr. Charlie McCreevy to the Select Committee on Finance and the Public Service –

> 'It seeks to close off a loophole that has arisen because of some of the changes I introduced. Since I abolished upper limits, those associated with specific [Religious] Orders have transferred the whole of their income to the Order and have therefore attracted total tax relief. Their full PAYE liability was set off by the relief on the charitable contribution. Of the €11 million foregone, €9 million is derived from this aspect. I do not wish to classify it as avoidance speculation because in many instances it has probably been done by those in Religious Orders for sound reasons. That was never the intention. In view of this I propose to limit the amount of relief available to those closely connected to these Orders to the effect that they will be only able to transfer 10% of their income.'[65]

Finance Act 2005 provided that to qualify under the scheme a charity must have charitable status for two years rather than the original requirement of three years.

3.7 When the scheme was introduced all charities and approved bodies were circulated with a copy of the Revenue information leaflet on the scheme.[66] The

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[63] Financial Statement of the Minister for Finance, 8 February 1995.
[64] On the introduction of the euro this limit became €250.
[65] Minister for Finance to Select Committee on Finance and the Public Service, 25 February 2003.
[66] Office of the Revenue Commissioners, *Tax Briefing, July 2001, no. 44*, www.revenue.ie

scheme was welcomed by the Charity Sector - a 2002 press release from the Irish Charities Tax Reform Group (ICTRG) noted[67] -

> 'ICTRG is pleased to acknowledge the new tax relief on donations to charities introduced by Minister McCreevy in the Finance Act 2001. From the 6th April 2001, tax relief is available on donations of €250 or more in any one tax year to eligible charities from both individual and corporate donors with no upper limit on the amount of donations that qualify for relief. Tax relief is applied to these donations at the donor's marginal rate of tax.
>
> There is no question that this tax effective giving mechanism is a major benefit to charities and was warmly and very publicly welcomed by ICTRG but it is one that brings us into line with existing practice in the UK, US, Australia, New Zealand and Canada where incidentally there is either no lower donation threshold at all or a minimal one i.e. $5. This change allows individuals and companies to give to charities in a tax efficient way and does encourage philanthropy in Ireland.'[68]

The ICTRG undertook to the then Minister when seeking the scheme not to seek further tax advantages if it was introduced.

Charity in Ireland

3.8 The *Statute of Charitable Uses 1601* and the *Statute of Charitable Uses 1634* are widely acknowledged as the statutory foundations for determining what constitutes a charitable purpose in Ireland. The decision in the 1891 case, *Commissioners for Special Purposes of Income Tax v Pemsel* set out guidelines for use in determining what a charitable purpose is. According to these guidelines a charitable trust must be either for:

- the relief of poverty;
- the advancement of religion;
- the advancement of education; or
- other purposes beneficial to the community.

In addition, the purpose must also benefit the community or an appreciable section of the community and be exclusively charitable.[69] These four headings and their underlying principles – known as the Pemsel categories – are used by the Revenue Commissioners to establish whether an applicant group is entitled to charitable status.[70]

[67] It is understood that the ICTRG represents 80% of the activity in the charity sector.
[68] 'Deirdre Mortell Chairperson of ICTRG responds to Minister McCreevy's "No VAT Refund for Charities" argument', Press Release, 15 May 2002, www.vatcampaign.com.
[69] Law Society's Law Reform Committee (2002), *Charity Law: The Case for Reform,* p .41.
[70] Any applicant body refused exemption has a legal right to appeal that decision to the Taxes Appeal Commissioners, who are independent of the Revenue Commissioners, once there is evidence that the body is legally established and that some tax charge has been incurred by them e.g. DIRT on a deposit account, stamp duty incurred on the purchase of a property etc.

3.9 To date, there is no statutory requirement to register as a charity in Ireland and no one body has been tasked with regulating the conduct and affairs of charities. As outlined by the Department of Community, Rural and Gaeltacht Affairs, currently the Attorney General is the protector of charities under the Charities Act 1961 and the vestiges of the common law which still apply to this area. The Revenue Commissioners have responsibility for the administration of the charitable tax exemptions under the Taxes Consolidation Act 1997. The Commissioners of Charitable Donations and Bequests for Ireland are an enabling body. In accordance with the powers conferred on them under the 1961 and 1973 Charities Acts, the Commissioners can assist charities in situations where the trust deed does not provide sufficient powers for those trustees. They also provide low cost means of applying a gift to an alternative charitable purpose through a *cy-près* application[71]. The Gardaí investigate any breaches of the criminal law by charities and the Director of Public Prosecutions or the Gardaí prosecute any breaches. The Gardaí also issue collection permits under the Street and House to House Collections Act 1962. The Director of Corporate Enforcement and the Registrar of Companies have a role in the supervision of charities that are limited companies. The Valuation Office administers the exemption from rates and the Probate Office keeps the Commissioners of Charitable Donations and Bequests informed of charitable bequests.[72]

3.10 The Agreed Programme for Government between Fianna Fáil and the Progressive Democrats of June 2002 contains the commitment that a 'comprehensive reform of the law relating to charities will be enacted to ensure accountability and to protect against abuse of charitable status and fraud.'[73] The Department of Community, Rural and Gaeltacht Affairs has established a Charities Regulation Unit to establish a modern statutory and regulatory framework for the sector. They produced a consultation document on "Establishing a Modern Statutory Framework for Charities" and as a result brought proposals to the Government. Heads of a bill are currently being drawn up. As part of this process, issues will arise such as the definition of a charity, the link between the achievement of charitable status under the new statutory regime and the award of tax-exempt status by the Revenue Commissioners etc.

Charities and Taxation

3.11 Under Section 848A of the Taxes Consolidation Act 1997 (TCA, 1997), a charity or body can apply for authorisation as an 'eligible charity' after it has been granted exemption from tax and assigned a CHY number by the Revenue Commissioners for a period of not less than two years. The tax code provides exemptions for charities as follows:

- Income Tax - Sections 207 and 208, TCA, 1997
- Corporation Tax (in the case of companies) - Sections 76 and 78, TCA, 1997
- Capital Gains Tax - Section 609, TCA, 1997

[71] In determining a *cy-près* applications, the Commissioners of Charitable Donations and Bequests for Ireland ensure that all charitable donations, whether willed or otherwise, are applied to charitable ends, even where the original charity no longer exists or the aims of the charity have been changed. Department of Community, Rural and Gaeltacht Affairs, (2003), *Establishing a Modern Statutory Framework for Charities – Consultation Paper*, www.pobail.ie, p. 10.

[72] Department of Community, Rural and Gaeltacht Affairs, (2003), *Establishing a Modern Statutory Framework for Charities – Consultation Paper*, www.pobail.ie, p. 11.

[73] Agreed Programme for Government between Fianna Fáil and the Progressive Democrats, June 2002, p. 29.

- Deposit Interest Retention Tax (DIRT) - Section 266, TCA, 1997
- Capital Acquisitions Tax - Section 76, Capital Acquisitions Taxes Consolidation Act, 2003
- Stamp Duty - Section 82, Stamp Duties Consolidation Act, 1999
- Dividend Withholding Tax – Section 172C(2) (e), TCA, 1997
- Professional Services Withholding Tax – Section 15, Finance Act 2005

3.12 A charity will only be granted charitable tax exemption if it is legally established in the State and has its centre of management and control here. The majority of its directors must be resident within the State and the organisation must have a permanent establishment and conduct some operations within the State. Every newly-exempted organisation has to provide their first year's financial accounts together with a report on activities to Revenue. This allows for a check to ensure that it has commenced work and that its activities accord with those represented at the application stage. In some instances, this eighteen-month review has resulted in the withdrawal of the exemption. In addition to these reviews, Revenue also operates a long-term monitoring procedure under which entities granted exemptions are selected for review. It is understood from the Revenue Commissioners that for the most part, these reviews continue to indicate a high standard of compliance with the terms of the exemption. In addition, Revenue estimated that 50% of the charities, and most approved bodies, apart from schools, are incorporated; accordingly, they are obliged under company law to lodge annual accounts with the Companies Office. As of September 2005, some 6,600 bodies had been granted charitable tax exemption and the Revenue Commissioners receive in excess of 500 applications annually. A list of exempted bodies is available on Revenue's website www.revenue.ie. This list is updated on a monthly basis to take account of newly-exempted charities and those bodies, who for one reason or another, are no longer exempted. For instance, they may disband once their aim has been fulfilled or Revenue's review process may result in the exemption being withdrawn.

3.13 While no overall definitive figures are available on the cost to the Exchequer of charitable tax exemption status, Revenue has estimated that the cost of the various tax exemptions that are in place in the case of charities could be as high as €100m annually. They arrive at this by considering:

- the cost of the annual income tax and corporation tax exemptions of the income of over 6,600 charities;
- the at-source exemptions in place for deposit accounts (DIRT) and also the at-source exemptions for Dividend Withholding Tax (DWT) in respect of Irish Stock Exchange holdings held by certain charitable trusts;
- gift and inheritance tax exemptions;
- while there is no general relief from VAT for charities,[74] there are a number of particular reliefs available e.g. on vehicles for disabled, medical equipment, goods purchased for export for humanitarian relief;
- VRT and Excise Duty reliefs on vehicles and fuel used by bodies in the transport of persons who are severely and permanently disabled.

[74] Charities and non-profit groups are governed by EU VAT law with which Irish VAT law must comply. Charities are exempt from charging VAT on the services they provide and cannot recover VAT incurred on goods and services that they purchase. Essentially only VAT registered businesses which charge VAT are able to recover VAT.

To the forgoing must be added the following tax cost and types, based on 2004 outcomes:

• CGT – Revenue clearances issued to 30 charities for property disposals with an aggregate value of €250m	€50 m (*up to)*
• PAYE refunds under the Donations Scheme	€14.8m
• Other refunds to charities (PSWT, DWT etc.)	€4.5m
• Stamp duty exemption	€5.5m

The above figures do not take into account the cost of the rates exemptions/reliefs operated by Local Authorities in the case of charity properties.

Effects of the scheme

3.14 The effects of the scheme must be looked at from three perspectives, that of

- The Exchequer
- Charities and approved bodies
- Donors

The cost of the relief in terms of tax foregone

3.15 The Office of the Revenue Commissioners is the main source of information, statistics and data on tax incentives/expenditures. Revenue's primary function is firmly based around the administration of the tax system and the collection of tax. The collection of statistical information flows from that function. The simplification of the system of tax returns has meant that the identification of individual schemes is not always possible as details are captured in aggregate form on tax returns.

3.16 The Revenue Commissioners collect data on donations made by PAYE taxpayers when charities and approved bodies apply for refunds. Since 2002 there has been an exclusive code for donations on the self assessment tax return form so consequently data relating to that sector is gradually coming on-stream. Corporations claim donations as a trading expense and there is currently no "stand-alone" code on the tax return form to capture data for costing the scheme.

3.17 In 2001, it was estimated that the cost to the Exchequer for this relief would be £8m (€10m) in 2001 and £23m (€29m) in a full year.[75] While it is not possible to say at the moment with certainty what the scheme is costing, it is likely to be still below this projected cost. The cost, however, is likely to rise as organisations become more aware of the scheme and they in turn inform their donors and encourage them to give in a tax efficient way.

[75] PQ 12343/01, 1 May 2001, Dáil Éireann, vol. 535.

Cost of Section 848A of the Taxes Consolidation Act 1997

YEAR	Amount of tax refunded by Revenue to Charities and other Approved Bodies in the case of individual PAYE donors.	Revenue estimate of tax foregone in the case of donations made by self – assessed individuals.	Donations by Companies.
2002	€11.2m	€5.1m	As donations made by companies are cumulated with other expenses in corporate tax returns, it is not possible to extract a figure for donations.
2003	€21.4m	Not yet available	
2004	€14.8m	Not yet available	
2005 (to 30 Sept.)	€9.2m	Not yet available	

How charities and approved bodies are affected by the Scheme

3.18 The scheme is available to all eligible charities and approved bodies. This is in keeping with the principle of economic efficiency as stated by Banks and Tanner (1998) –

> 'tax relief should be neutral between different types of charitable giving and apply equally to all charitable causes. Government policy should not distort individual choices over which charities to give to unless there is an identifiable additional market failure for some charities and not for others that the government is seeking to correct.'[76]

While there are currently some 6,600 tax exempted charities on Revenue's website, only 1,740 of them have to date been approved as *eligible charities* under the scheme. Some 800 charities have yet to complete the two-year run-in period, which leaves over 4,000 charities who have not applied for scheme authorisation. This includes however, many charities such as private trusts who do not solicit donations from the public and other charities that are substantially or wholly funded by the State.

3.19 Schedule 26A of the Taxes Consolidation Act 1997 lists the approved bodies for the purposes of Section 848A. This list includes a number of individual bodies which are, with one exception, bodies that have been approved under reliefs that existed prior to the introduction of the scheme.[77] As these bodies did not qualify under the new general scheme and as it was decided not to disqualify any existing body, it was necessary to list these bodies individually to enable them to continue to qualify for relief under the new uniform scheme. It was not envisaged that individual organisations would be routinely added to the scheme thereafter but rather that such organisations would qualify for the relief on the basis that they were eligible charities or other categories of approved bodies listed in the schedule.

[76] Banks, James and Sarah Tanner (1998), *Taxing Charitable Giving*, Institute of Fiscal Studies, p. 10.
[77] An exception was made in the case of US-Ireland Alliance. The Alliance was listed in Part 1 of Schedule 26A in Finance Act 2003. The US-Ireland Alliance is a non-profit making organisation dedicated to consolidating existing relations between the US and Ireland and building that relationship for the future.

3.20 It is very difficult to determine and place a monetary value on the benefits arising from the scheme. The charities and approved bodies using the schemes are diverse and often produce intangible benefits which are difficult to identify and value. The role of such groups is wide ranging, encompassing amongst other areas the education, health, community and religious sectors. This role is generally seen as important in the achievement of government policy and the development of society. This was recognised in the *White Paper on a Framework for Supporting Voluntary Activity and Developing the Relationship between the State and the Community and Voluntary Sector* published in 2000, which stated -

> 'Voluntary activity spans the whole range of social activity and is a vital element of democracy. A strong democracy enhances and protects the capacity of citizens to participate. In a strong democracy people regard the State, not as the answer to every problem, but as just one player among others. All the others – the private sector, trade unions, religious institutions, non-governmental organisations, sporting organisations, local community and resident's associations – play a pivotal role in democratic life and in continued economic and social progress…
>
> The Government regards statutory support of the Community and Voluntary sector as having an importance to the well-being of our society that goes beyond 'purchase' of services by this or that statutory agency. The Government's vision of society is one which encourages people and communities to look after their own needs – very often in partnership with statutory agencies – but without depending on the State to meet all needs.'[78]

3.21 The White Paper noted that the community and voluntary sector has a long and valued tradition in meeting social needs in Ireland and over the years the State has gradually played a wider role in funding the sector. In 1999, almost €1.3 billion in funding was provided by the Irish State and EU sources for the sector.[79] Awareness of this important role is reflected in the fact that they are playing an increasing role in national social partnership agreements. A large network of community and local development has built up in Ireland over recent decades and many of these groups are issue-based, such as groups concerned with homelessness, poverty, health care, drug abuse, services for the disabled, care of the aged etc. They are active in –

- delivering essential services
- advocacy and provision of information
- contributing to policy-making
- national and local partnership arenas
- undertaking research
- creation of opportunities for members and participants to access education, training, income and employment opportunities.[80]

[78] Department of Social, Community and Family Affairs (2000), *White Paper on a Framework for Supporting Voluntary Activity and Developing the Relationship between the State and the Community and Voluntary Sector*, www.welfare.ie, pp. 9-10.
[79] Department of Social, Community and Family Affairs (2000), *White Paper on a Framework for Supporting Voluntary Activity and Developing the Relationship between the State and the Community and Voluntary Sector*, www.welfare.ie, p. 16.
[80] Department of Social, Community and Family Affairs (2000), *White Paper on a Framework for Supporting Voluntary Activity and Developing the Relationship between the State and the Community and Voluntary Sector*, www.welfare.ie, pp. 17-18

These goods and services are in many ways ‘collective’ in their benefit, in that they confer a benefit to society over and above the benefits that the recipient or supplier may get from the arrangements, and as a consequence tend to be under-supplied.

3.22 Bearing this in mind, Section 848A was designed to further support this sector and also to encourage charitable giving, which is generally regarded as socially desirable behaviour. The timescale involved and the data available mean that it is not possible to place a monetary value on the work done by the groups benefiting from this tax relief because as mentioned above the work they carry out is diverse and generally not marketed – it is not possible with any degree of accuracy to estimate the effect of an increase in donations on the pupils in a school, the clients of a museum, the recipients of third world aid etc. Also, in the absence of accurate data on the level of donations prior to the introduction of Section 848A it is hard to quantify the impact of the scheme on the level and size of donations. However, one measure of the benefit of the scheme is the value of the tax foregone; this gives an indication of how the charities and approved bodies and donors are benefiting from the scheme.

3.23 When a PAYE taxpayer donates money to a charity or approved body the relief is given on a grossed-up basis in the form of a refund to the body. The breakdown of such refunds in 2004 is as follows:

PAYE refunds under Section 848A made by Revenue in the 2004 in respect of donations received in the 2003:

Charitable Category	Number of Charities/Bodies getting refunds	Number of Valid PAYE Donors	Refund Amount €m	% of Total Refund
Religion	398	15,945	9.7	65.5
Community	59	2,331	0.9	6.1
Poverty	29	6,983	2.9	19.6
Approved Bodies	101	4,500	1.3	8.8
TOTAL	587	29,759	14.8	100

As can be seen from the foregoing table, refunds to groups involved in religion made up the majority of the refunds in 2004, accounting for 65.5% of the total. Of that 65.5%, more than half of the refund went to religious orders notwithstanding the 10% income cap introduced in the 2003 Finance Act. Revenue analysed the returns relating to religion and determined that –

- 80 refunds amounting to €5.5m were made to religious orders;
  Refunds under this category are put to a number of uses including the care and maintenance of elderly members of religious orders and third world missions undertaken by certain religious orders.

- 308 refunds amounting to €4.09m were in respect of dioceses, parishes and churches;
  It seems that the refunds under this category form part of the general operating funds for dioceses, parishes and churches. In certain instances, specific church/cathedral repair or renewal programmes have featured;

- 10 refunds amounting to €0.12m were made in the case of religious support groups of various types.
  This category embraces a number of activities including catechetic bodies and general religious recruitment/promotional type bodies.

The scheme is still relatively new and it is likely that some charities were better positioned to avail of the relief early on. As time progresses more charities and approved bodies are likely to make greater use if it.

The impact on Charities

3.24 Charities welcomed this relief on its introduction and have indicated to the Department of Finance that they have benefited form it. The Irish Charity Tax Reform Group (ICTRG), which, it is understood represents 80% of the activity in the charity sector, made a submission to the public consultation process undertaken as part of the overall 'Review of Tax Reliefs and Exemptions for High Earners'. In response, the Department requested a meeting with the ICTRG to discuss their submission and seek further information.[81] In advance of that meeting, the ICTRG quickly surveyed about 140 of its members, one third of whom responded – 54% of these respondents said that the relief had made a difference to them but they could not isolate the effect of the scheme as fundraising efforts had also made a difference in increasing donations, 46% said it had made no real difference to them because they do not receive donations over €250, the threshold for this relief. The ICTRG noted that there is a correlation between the size of the charity and the benefit of the scheme, with larger charities in a better position to attract donations above the threshold. Some charities have persuaded existing donors that were previously close to the threshold to increase their donation to over the €250 limit so that tax relief could be claimed. Other charities are working on gradually persuading donors to increase their donation up to the threshold. Some charities rely on other means of fundraising and do not use the scheme, for example, health charities rely heavily on legacies. The ICTRG reported that since the introduction of the scheme there is evidence that some charities are pitching their fundraising at the threshold of €250, this is usually done by encouraging donors to make their donations by way of direct debit. The ICTRG pointed out if the threshold was reduced to €100 more charities would benefit from the scheme.

3.25 The ICTRG also indicated that it was their view that donors are gradually becoming more aware of the scheme. They also noted that a greater range of sectors (health, education, homeless organisations, religious etc) are benefiting and they reported that there was no evidence of displacement in donating patterns since the introduction of the scheme. Third World charities have not experienced a reduction in their donations due to the widening of the scheme to domestic charities and approved bodies.

3.26 In late November 2005, the Irish Charities Tax Research Group, a sister organisation of the ICTRG, sent to the Department of Finance for information the

[81] The Department of Finance gratefully acknowledges the assistance of the ICTRG and Irish Charities Tax Research Group in providing valuable information in relation to the charities sector in Ireland.

results of a survey it had carried out into estimating the additional cost to the Exchequer of reducing the donation threshold on Section 848A tax relief.[82] They surveyed 2,014 organisations and received 599 replies of which 391 were considered valid responses, giving a response rate of 19%. The sampled charities received a total of €34 million in donations from individuals in 2003 of which 42% was accounted for by donations of €250 or more, 27% of donations between €100 and €249 and the remaining 31% less than €100. They determined that only 13% of the charities sampled currently benefit from the tax relief scheme on donations of €250 or more from PAYE only donors. These charities tend to be established for more than ten years and larger as measured by annual income and number of employees. They are also proportionally more likely to be fully-funded from private sources of income though not exclusively so. Of the non-availing group the majority tend to be small to medium sized charities which depend largely on a combination of public and private income sources.

The Irish Charities Tax Research Group noted that if the threshold was reduced to €100 then an additional 32% of the sampled charities could benefit from the scheme bringing the total of those benefiting up from the current position of 13% of charities to a potential 45% of charities. Of the remaining 55% of charities a small proportion are totally publicly funded with the remainder either relying exclusively on event-based fundraising or a combination of mainly event raised income, with possibly some corporate donations, public funding or foundation grants and where applicable low levels of individual donations i.e. generally well below €100 per donor per annum.

They suggest that reducing the threshold to €100 would spread the benefit to a much greater number of medium and small charities and it would act as a 'significant stimulus' to the fundraising efforts of those charities. They estimated that if the threshold was reduced from €250 to €100 the annual cost to the Exchequer of the scheme would be €44.8 million. In this calculation they assume that reducing the threshold to €100 would stimulate 50% of donors who currently donate less than €100 to increase their donation to the threshold. They note that this however is an optimistic assumption because charities in the research sample indicated that lowering the threshold to €100 might incentivise a small proportion of donors to increase their donations to €100 but the majority of donors would never come near this amount. The average donation in the 'less than €100' category based on this research was €37.[83]

Having considered the research it is clear that reducing the threshold would increase the amount refunded to charities and approved bodies as they would be able to claim relief on donations between €100 and €250. However, it is not certain that a reduction in the relief would lead to a change in behaviour and a consequent increase in donations. The purpose of the scheme is to increase donations, not to top-up existing donations. Further research is needed into the behaviour of donors in order to determine if reducing the threshold would lead to greater donations, or whether it

[82] Irish Charities Tax Research Ltd and John Dempsey (2005), *Tax Relief on Donations to Eligible Charities and Approved Bodies – the cost of reducing the qualifying threshold from €250 to €100.*
[83] Irish Charities Tax Research Ltd and John Dempsey (2005), *Tax Relief on Donations to Eligible Charities and Approved Bodies – the cost of reducing the qualifying threshold from €250 to €100.*

could just lead to existing donations becoming eligible for tax relief at a significant deadweight cost to the Exchequer.

Schools

3.27 Since the scheme was introduced, 79 schools have lodged PAYE–donor refund claims with the Revenue Commissioners. In 2004, 16 private fee-paying and 45 non-fee paying schools claimed refunds to the value of €831,000. As part of the ongoing monitoring of the scheme, the Revenue Commissioners reviewed the operation of the scheme by 27 schools – including all the private fee-paying schools. Revenue was satisfied that in general the schools are not abusing the scheme– the money raised is either being used for capital projects within the school or used for the general running of the school. Revenue has entered into discussions with the one school where Revenue was concerned that donations might be used as a substitute for fees. Subsequently, during summer 2005, Revenue wrote to all fee-paying primary and secondary schools in the country reminding them that school fees or contributions/donations substituting as school fees are not allowable under the scheme. The donation must not confer any benefit on the donor or any person connected with the donor. This issue can be difficult to determine in the case of a parent making a donation to their child's school. To date, Revenue have judged this issue on the basis of whether the donation is voluntary or compulsory – so long as parents are not obliged to pay and the children of non-donating parents are not discriminated against, then it is deemed to satisfy the terms of the relief.

3.28 Under this scheme, schools that are not recognised by the Department of Education and Science for funding purposes can nevertheless participate in the scheme. This arises because the legislation for the scheme describes schools as –

> An institution or other body in the State which provides primary education up to end of sixth standard, based on a programme prescribed or approved by the Minister for Education and Science.
>
> An institution of other body on the State which provides post-primary education up to the level or either or both the Junior Certificate and the Leaving Certificate based on a programme prescribed or approved by the Minister for Education and Science.[84]

Section 10 of the Education Act 1998 outlines the Department of Education and Science criteria for recognising schools.[85] The Department of Education and Science does not recognise or provide funding for fee-paying primary schools but these may be eligible for inclusion for relief under Section 848A as they may be teaching the programme prescribed or approved by the Minister for Education and Science to sixth standard. This places Revenue in an awkward position as it is not within its remit to judge the level and type of teaching taking place in schools. For the moment, the situation should be monitored and if it is deemed to be posing difficulties, consideration could be given to changing the definitions of schools in Section 848A to allow only schools recognised by the Minister for Education to avail of the scheme.

[84] TCA 1997, Schedule 26A, Donations to Approved Bodies, etc.
[85] Education Act, 1998, www.gov.ie/bills28/acts/1998/a5198.pdf

This move would however lead to the exclusion of seven private primary schools that are currently availing of the scheme.

<u>Universities</u>

3.29 Donations to third level institutions, including universities, are also eligible for this relief. A significant proportion of university donations come from donors based overseas who do not benefit from Section 848A relief. The Conference of Heads of Irish Universities (CHIU) has indicated that for the following four Irish universities the approximate average annual donations received over the past 5 years that were eligible for tax relief under Section 848A were as follows:-

- Trinity College Dublin — €6.5 million (42% of all donations over the period)
- University College Dublin — €3 million (25% of all donations over the period)
- NUI, Galway — €1.6 million (23% of all donations over the period)
- University College Cork — €0.9 million (13% of all donations over the period)

CHIU estimated that for the other three universities the approximate average annual donations which would have been eligible for tax relief under Section 848A would be in the region of €1-2 million each. To date the Revenue Commissioner have had no PAYE refund claims from universities.

How donors are using the scheme

3.30 A survey conducted in 2005 by the Behaviour and Attitudes Company provides useful information on amounts contributed to charity in recent years. A face-to-face survey of 1,200 people was conduced in early August 2005 and asked people about their donations to charity in the previous three months (May, June and July 2005).

Average Amount Contributed to Organisation, May-July 2001-2005 (€)

Organisation Type	2001	2002	2003	2004	2005
Illness/Handicap	12.30	12.24	15.89	49.54	32.89
Third World	12.73	14.80	21.15	29.85	53.03
Poor/Elderly	10.20	11.99	15.27	21.47	29.86
Paramedical/Life Saving	11.98	14.43	24.62	25.02	20.43
Youth	8.24	7.39	26.32	13.70	11.54
Overall Average Contribution	**32.25**	**34.69**	**42.01**	**81.34**	**90.86**

Source: Behaviour and Attitudes Marketing Research, 2005

The results (table above) suggest that the overall average contribution for the quarter has increased over the last five years to €90.86, with the third world charities getting the most. While taking the figures for one quarter and multiplying them by four to get an annual estimate will not give an entirely accurate picture of what happens over the course of the year because some respondents may over-represent the amount they give, others may forget what they have donated and it is possible that some contributions might be made once a year and just happen to fall into the quarter under review. On balance such impacts are likely to be cancelled out. These figures would suggest that the average annual contribution is in the region of €360, which is above the threshold for tax relief. However, what is likely to be happening in many cases is that people are spreading their donations across a number of charities and are not giving a minimum of €250 to any one eligible charity or approved body and therefore not benefiting from the relief.

3.31 An analysis of the amounts donated shows that people are giving more. In 2003, 20% said that they had made no contribution to charity or they did not know if they had made a donation; this has fallen to 13% in 2005. In 2003, 25% of respondents had given less than €10; this had fallen to 15% by 2005. At the other end of the spectrum, the proportion of those giving over €110 in the quarter has risen to 12%, from 5% in 2003.

Contributions to Charities, May-July 2001-2005

	2003		2004		2005	
	Numbers	%	Numbers	%	Numbers	%
Up to €10	721	25	535	18	469	15
€10-€43	1015	35	1123	37	1110	36
€44-€110	481	16	793	26	744	24
€110 +	138	5	341	11	362	12
Don't know	83	3	27	1	348	11
None	497	17	227	7	51	2

Source: Behaviour and Attitudes Marketing Research, 2005

This data suggests that the amounts being donated are increasing. Whether this increase is the result of growing awareness of the tax relief is unclear. Other things being equal, the likelihood of being a donor to charity increases with age, income and wealth.[86] Hence, it could be expected that charitable donations in Ireland would have increased over the last decade with increased economic growth. It is therefore impossible to say with any certainty if the existence of the tax relief has led to a higher level or a greater number of donations. What is clear however is that there is an upward trend in donations which charities should capitalise on by encouraging donors to plan their giving in a tax efficient manner.

3.32 For the relief to be effective it has to be the spur that prompts people to donate. International evidence suggests that this is not always the case. The United Kingdom has introduced a very comprehensive set of reliefs to encourage donations (see Appendix 2). Despite all these reliefs, a recent report commissioned by Revenue and Customs in the UK to increase understanding of the relationship between charitable giving among individual citizens and the tax relief available on their gifts noted that the total value and frequency of charitable donations made by individual citizens in Britain has remained unchanged since 1988 despite the introduction of various forms

[86] Banks, James and Sarah Tanner (1997), *The State of Donations: Household Gifts to Charity, 1974-96*, Institute for Fiscal Studies, p. 1.

of tax relief. The report noted that there seems to be no direct relationship between the rules of tax relief and the amounts people give. In the reasons people gave for giving and not giving, or claiming and not claiming, few said that a calculation of the added value of tax relief determined how much they gave to charity.[87]

The Irish scheme is still relatively new and awareness of it is increasing. Data is still coming on stream regarding the cost and take-up of the scheme. Information to date suggests that people are increasingly using the scheme and in time it will be easier to determine if the relief is prompting increased giving.

- *PAYE donors*

3.33 For PAYE workers the relief is given on a grossed-up basis to the body. This means that the donor does not get a benefit beyond the feeling of satisfaction from the knowledge that their donation will secure the benefit of extra revenue to the charity or body. The charity or approved body claims the relief which is grossed up to the donor's marginal rate, so for an individual donor paying income tax at 42%, the value of the donation is increased by 72% as a result of the tax relief.[88]

PAYE Donors 2002-2005

Year	PAYE taxpayers availing of scheme	Gross Contributions - i.e. Donation + Tax Relief	Cost to Exchequer[89]
2002	19,743	€39.5m	€11.2m
2003	29,626	€75.4m	€21.4m
2004	29,761	€81.1m	€14.8m
2005 (to 30 Sept)			€9.2m

- *Self Assessed*

3.34 A donor that is a self assessed taxpayer claims the relief as a deduction to their tax bill. There is no grossing-up arrangement.

For the tax year 2001, Section 848A shared a code on the self-assessment form with tuition fees so is difficult to get reliable data in respect of donations to charities and approved bodies. However, preliminary indications suggest that self-assessed taxpayers are using the scheme, with the largest donations coming as might be expected from those with the highest income. This is in keeping with one of the aims of the scheme which was to encourage a sense of philanthropy amongst those with high incomes.

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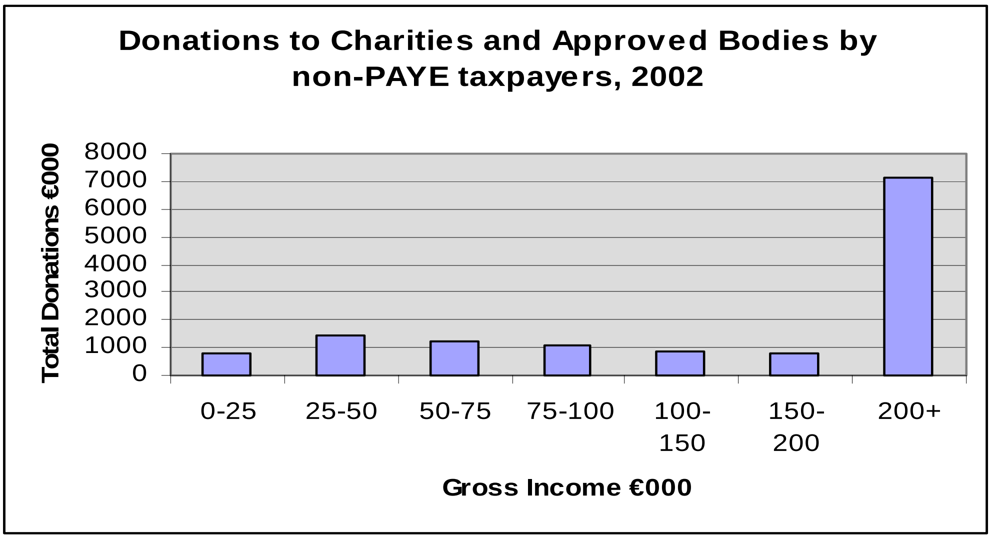
[87] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, p. 4.

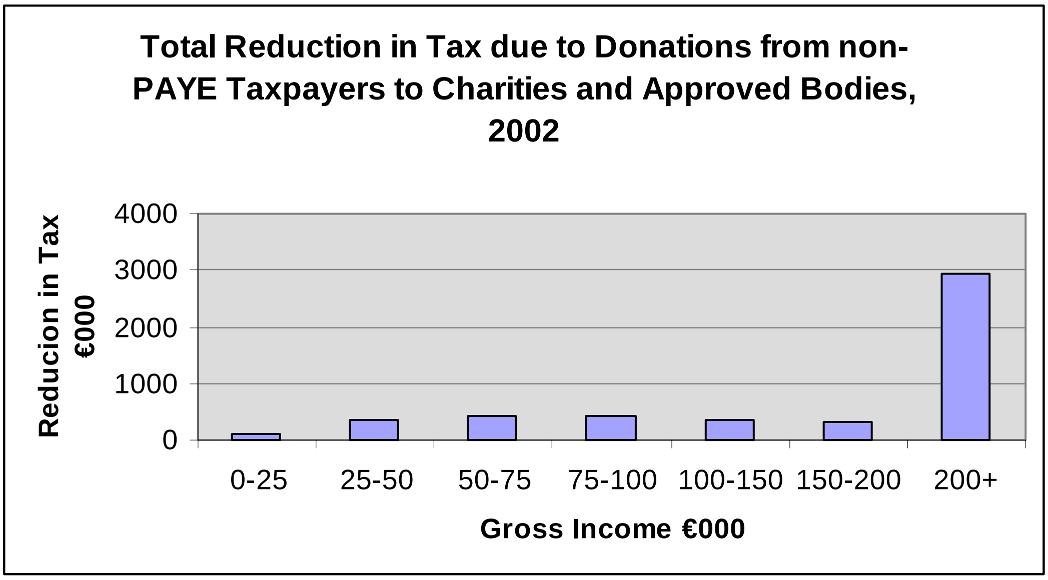
[88] The tax refund to the charity or body is calculated as follows – Amount of Gift * (marginal rate of income tax)/(100-marginal rate of income tax). Thus, if a PAYE taxpayer wishes to ensure that a charity or body receives €1,000, he/she donates €580, the charity claims the tax at 42% on the "grossed-up" amount of €1,000; the donation of €580 from after-tax income is increased by 72% by Revenue's refund of €420.

[89] The reduction in cost to the Exchequer in 2004 over 2003 is due to the introduction of the provision in Finance Act 2003 whereby if a donor is associated with the charity/body to which he/she donates, the maximum amount that can attract relief is 10% of the individual's total income.

Non-PAYE taxpayer claims to Revenue in 2002:

Range of Gross Income		Totals		
From	To	Number of cases	Amount of Donations to Approved Bodies	Reduction in Tax[90]
€	€		€	€
0	25,000	772	789,141	112,561
25,000	50,000	1,463	1,428,137	363,543
50,000	75,000	997	1,223,418	429,225
75,000	100,000	560	1,064,524	415,688
100,000	150,000	560	856,725	346,355
150,000	200,000	323	800,720	332,472
Over	200,000	933	7,109,310	2,923,734
	Total	**5,608**	**13,271,975**	**4,923,578**





[90] Revenue indicate that when the total figures in the table are "grossed up", allowing for under coverage of tax returns at 95.3% in 2002, the cost to the Exchequer is €5.1M.

3.35 A review of the tax files of individuals with high incomes by Revenue indicates that in 2002, 63 of the top 400 individuals with high incomes claimed tax relief on donations of €5.4m under Section 848A. The eligible donations ranged from €250 to €2.9m, with an average of close to €86,000. While these donors account for a significant proportion of the overall relief claimed, this is in keeping with the original aim of encouraging those with significant incomes to donate to charities and other bodies. The Revenue Commissioners estimate that the tax forgone from these taxpayers through their use of this scheme is in order of €2.4m.

3.36 There is very little information available on who these taxpayers are donating to. Revenue carried out a review of the cases involved and nine of these taxpayers provided information on who they were donating to, namely museums, third world charities, second and third level educational institutions, domestic and health charities. While individuals with high incomes are making significant use of this scheme, it must be noted, of course, that the recipients of this tax relief make no personal gain from their donations. It is a very different scenario than a relief given on investment from which the investor is subsequently going to personally benefit.

- *Corporate*

3.37 Companies claim the donation as if it were a trading expense. According to the ICTRG, charities for the most part rely on individual rather than corporate donations. Their experience has been that donors tend to donate as individuals rather than through corporate donations – this may be due to two reasons (i) the tax relief is greater if the donation is made by an individual, and (ii) people tend to donate to what they believe in. This view is supported by academic research (see Appendix 1). Donoghue (2000) noted in her study of corporate donations in Ireland that 'corporate donations, although important for marketing and the company's self image, do not yield a huge amount to the non-profit sector'.[91]

Survey of corporations

3.38 Due to the way companies claim this relief, their tax returns to Revenue do not allow for the costing of this relief to them. However, in considering the impact of the tax relief it is necessary to look at the success of the scheme in attracting donations from companies. Accordingly, the Department of Finance carried out a survey of companies. From the *Irish Times* list of the Top 1000 Companies the top 25 non-financial companies, the top 10 financial companies and a random selection of 65 other companies were surveyed, bringing the total sample to 100. Companies were asked about the level and pattern of their donations and their reaction to the introduction of the scheme (see Appendix 3 for the text of the letter and the questionnaire). It must be borne in mind however, that the decision to make a donation is often arbitrary; it is not possible to map a relationship between this sample and the overall corporate population. However, this survey gives a snapshot of behaviour and trends across a selection of that population.

3.39 A 53% response rate was received.[92] The returns indicated that many companies do not give significantly to eligible charities and other approved bodies

[91]Donoghue, Freda (2000), *Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland*, National College of Ireland, p. 10.

[92] The Department of Finance gratefully acknowledges the assistance of the companies concerned.

and when they do tax relief is not the incentive (see table below). Twenty nine of the respondents have an annual donations budget and four others said that while they do not have a budget, they make donations. The total amount donated by these thirty-three companies in the last year was in the region of €15 million, with an average donation of €465,000. These figures are skewed by two companies and omitting them leads to an average donation in the region of €140,000. In all cases, the level of donations made represents less than 1% of the company's turnover. The thirty-three respondents estimated that of the €15 million donated, €8 million is eligible for tax relief, leading to an estimated cost of €1 million to the Exchequer. It must be noted however that these donations include some once-off donations to tsunami relief. Companies also indicated that they also make money available to eligible charities and other approved bodies by way of sponsorship/advertising.

3.40 Responses indicate that there is a high degree of deadweight in the scheme. Of the fifty-three respondents, nine have increased the amount they donate to charities and approved bodies since the scheme was introduced while forty-three have not altered the amount they give and one company indicated that while they make money available to charities and approved bodies they do not use Section 848A, preferring instead to make money available by way of sponsorship. When asked how their pattern of giving has changed since the introduction of the relief, almost 30% of respondents indicated that they had increased the amount they give to domestic charities but most indicated that it had remained the same for schools, third level institutions, third world charities and other charities and approved bodies.

3.41 Of the thirty-three companies that give donations, eight indicated they would reduce the amount they give if the relief was abolished or reduced, twenty would not change the amount they give, two said that they might make a marginal reduction and three did not reply. With the majority suggesting that they would not react to a change in the scheme, this again points to high degree of deadweight. Not all indicated by how much they would reduce their donation but those that gave an estimate indicated that the reduction would, as might be expected, be in line with the level of corporation tax.

Summary Results of survey undertaken by Department of Finance

Response Rate: 53%[93]

Question	Reply
Do you have an annual budget for donations?	Yes = 29 No = 19 Do not have a budget but make some donations = 4 One company indicated that while they make money available to charities/bodies they do not claim relief under Section 8484A; instead contributions are made by way of sponsorship and deducted as a trading expense. Total = 53
If so what was the size of this budget in last calendar or accounting year?	Total Amount Donated by 33 companies = €15m.[94] Average Donation = €465,000 Companies also indicated that they also make money available to eligible charities and other approved bodies including sports bodies by way of sponsorship/advertising and through fundraising activities.
What percentage of your company's turnover does this represent?	Less than 1% in all cases
How much of your donations budget goes to charities and approved bodies and is tax deductible under the scheme of tax relief for donations to eligible charities and other approved bodies?	Total Amount by 33 Companies = €8m Average amount deducted = €254,000

[93] 52 replies were received but one reply incorporated responses for 2 organisations surveyed. Some companies did not answer all questions.

[94] These donations include some once-off donations to tsunami relief. Also included are donations made by the international subsidiaries of one of the larger donors. The value of vouchers given by one company to charities is also included – these are not eligible for relief under Section 848A.

Question	Reply	
Has the amount your company donates to charities and approved bodies increased **as a result of** the introduction in 2001of the scheme of tax relief for donations to eligible charities and other approved bodies?	Yes = 9 No = 43 One company indicated that while they make money available to charities/bodies they do not claim relief under Section 8484A. Instead contributions are made by way of sponsorship and deducted as a trading expense. Total = 53	
Since the introduction of the tax relief scheme for donations to eligible charities and other approved bodies in 2001 how has the amount you donate to the following areas changed?	Schools	More = 6 Less = 2 Same = 20
	Third Level	More = 5 Less = 2 Same = 21
	Domestic	More = 11 Less = 2 Same = 25
	Third World	More = 7 Less = 1 Same = 23
	Other	More = 2 Less = 3 Same = 22
Do you think that the amount your company donates would be reduced if the tax reliefs were reduced or abolished?	Of the 33 companies that make donations – Yes = 8 No = 20 No reply = 3 Possibly a marginal reduction = 2	
If yes, could you estimate by what percentage?	Most estimated by about 10-15%, which as expected is in line with the rate of corporation tax	

Monetary totals rounded

EU State Aid Policy

3.42 An eligible charity for the purpose of tax relief on donations is any charity in the State which has been authorised by the Revenue Commissioners as an eligible charity and which holds charitable tax exempt status from the Revenue Commissioners for at least two years. A charity will only be granted charitable tax exemption if it is legally established in the State and has its centre of management and control here. These conditions, and in particular the last mentioned, are regarded as essential for protection of the revenue of the State and prevention of fraud and money laundering. However, there are a number of court cases before the European Court of Justice which have raised issues which could have implications for the structure of Section 848A, in particular the condition that a charity must be established in the

State. It has been suggested that such conditions impact on the rights of freedom of establishment, freedom to provide services and the free movement of capital within the Community.

The European Court of Justice is currently hearing the case of Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften (C-386/04). In this case an Italian charity which is established and tax exempt in Italy receives rental income from property situated in Germany. The German tax authority has sought to impose tax on this rental income as it only grants tax exemption to charities established in Germany. The charity is seeking tax exemption on that income on the basis that an equivalent charity established in Germany would have such an exemption. This case is ongoing.

In addition, the European Commission has decided to refer Belgium to the European Court of Justice because in its view the Walloon inheritance and gift tax laws discriminate against foreign charities. These laws provide for reduced taxation of legacies and gifts to charity organisations, but exclude foreign charity organisations. The Commission considers that this violates the prohibition of discrimination on grounds of nationality and the freedom of establishment.

Separately, the European Commission has recently informally raised concerns regarding the compatibility of Section 848A with Community law. It is their preliminary view that the requirement for approved bodies to be legally established in the State is incompatible with Community law as it limits the tax relief to donations to Irish bodies/charities and could hinder such activities being undertaken by similar bodies/charities in other Member States. This is currently being examined by the Department of Finance.

Developments in these cases will have to be monitored and depending on the outcome there could be implications for the Structure of Section 848A, in particular in terms of the charities and bodies covered.

4. Scheme of Tax Relief for Relevant Donations to an Approved Sports Body for the Funding Of Approved Projects, Section 847A, Taxes Consolidation Act 1997

Background

Description of Scheme

4.1 Section 847A was introduced in Finance Act 2002. It is a scheme for tax relief for donations to approved sports bodies for the funding of approved capital projects. Eligibility for the relief centres on two key criteria – the sports body must be an *Approved Sports Body* and the donation must be for the purposes of an *Approved Project*. These criteria were put in place to reduce the scope for misuse of the tax relief. Speaking in the Dáil in 2002, the then Minister for Finance, Mr. Charlie McCreevy, said -

> "Section 41 [of Finance Bill 2002] provides for a scheme of tax relief on donations to certain sports bodies for the funding of capital projects. During last year's debate on tax relief for donations to charities I undertook to examine whether a similar relief could be given for donations to sports bodies. The changes I have made to the charitable donations area have been broadly welcomed by the charitable sector and I am happy to extend the same principle to donations for capital sports projects. I have always been positively disposed towards giving tax relief for donations to sports bodies and am confident that this new scheme will act as an important incentive for the continuing development and improvement of sports facilities throughout the State. The provisions contained in this Section of the Bill represent, in my view, a sensible approach to providing such relief. Eligibility for the relief will centre on two key criteria: the sports body must be an approved sports body and the donation must be for the purposes of a capital project costing under €40 million. If one gives a donation to a sports body for a capital project, one will get a tax break but the project must be certified by the Department of Tourism, Sport and Recreation as a capital project – in other words, one cannot get a tax break for ordinary membership of a GAA, golf or tennis club; it must be for a capital project."[95]

This was also argued by the Minister of State at the Department of Enterprise, Trade and Employment, Mr. Michael Ahern -

> "Over the last number of years there has been a drying up of funds for capital programmes in localities because of the large demands on people in their parishes for many different types of building projects. GAA, soccer and rugby clubs must collect money to buy pitches before doing some work on them. Their members then demand more sophisticated facilities and that means more money is needed but one cannot keep going back to the well. This Section's tax relief will be of benefit to those looking for funds, as companies and individuals can see they will get something out of it. This should help to raise funds for sports projects."[96]

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[95] Finance Bill, 2002, Committee and Remaining Stages, 21 March 2002, Seanad Éireann - Volume 169.

[96] Finance Bill, 2002: Second Stage, 14 February, 2002, Dáil Éireann, Volume 548

How the Scheme works

4.2 The scheme is applicable only to relevant donations to approved sports bodies in respect of expenditure incurred on approved projects received on or after 1 May 2002. The minimum qualifying total donation by a single donor in any year to an individual sports body is €250. No project will be approved which is estimated to cost in excess of €40m. However, where the aggregate cost of a project actually exceeds this amount, relief may only be claimed on donations up to the €40 million threshold. A relevant donation must be in the form of a sum of money, be for the sole purpose of funding an approved project, not subject to repayment and neither the donor nor any person connected with the donor can receive a benefit, whether directly or indirectly, as a result of making the donation.[97]

4.3 The arrangements for allowing tax relief for donations are the same as those for Section 848A. They depend on whether the donor is a PAYE taxpayer, an individual on self-assessment or a company. For PAYE taxpayers, the relief is given on a "grossed-up" basis to the approved sports body. In the case of a donation made by an individual who pays tax on a self-assessment basis, the individual claims a tax deduction for the donation in computing their total income - there is no grossing up arrangement. Similarly, in the case of corporate donations, the company is entitled to claim a deduction for the donation as if it were a trading expense in computing the profits of the company for the relevant accounting period.

4.4 An approved sports body is one established and existing for the sole purpose of promoting an athletic or amateur game or sport whose income is exempt from income/corporation tax, and has a current tax clearance certificate.[98] A list of approved sports bodies is available on the Revenue website at www.revenue.ie. An approved project means one or more of the following:

- the purchase, construction or refurbishment of a building or structure, or part of a building or structure to be used for sporting or recreation activities provided by the approved sports body,
- the purchase of land to be used by the approved sports body in the provision of sporting or recreation facilities,
- the purchase of permanently based equipment (excluding personal equipment) for use by the approved sports body in the provision of sporting or recreation facilities,
- the improvement of the playing pitches, surfaces or facilities of the approved sports body, and
- the repayment of, or the payment of interest on, money borrowed by the approved sports body on or after 1 May 2002 for any of the above purposes.

4.5 Projects coming under these categories are considered for approval for the purposes of this scheme by the Department of Arts, Sport and Tourism. If the Department is satisfied that the project comes within the categories outlined above, a certificate is issued to the approved sports body stating that the project is an approved project for the purpose of the tax relief. When an approved project becomes fully funded, the approved sports body should not accept further donations in respect of

[97] For further details see - Revenue Commissioners, *Tax Relief for Donations to Certain Sports Bodies,* www.revenue.ie/leaflets/gd02012d.pdf

[98] Section 235, Taxes Consolidation Act, 1997.

that project under this scheme. Where clubs applying for tax relief on donations towards a capital project have already been allocated funding under the Sports Capital Programme for that project, the Department of Arts, Sport and Tourism subtracts the amount of this funding from the amount the body is seeking approval for under the tax relief scheme. Similarly, where a club has had a project approved under the tax relief scheme and is subsequently allocated funding towards that project from the Sports Capital Programme, the Department of Arts, Sport and Tourism subtracts the amount of that allocation from the amount previously approved under the tax relief scheme and issues a revised certificate for the lower amount to the club. This ensures that the aggregate amount in grants and donations does not exceed 100% of the total project cost. The Minister for Arts, Sport and Tourism has the power to revoke this certificate.

4.6 Sports bodies are obliged to keep formal financial records in relation to its income and expenditure including donations received and expenditure incurred on approved projects. The Revenue Commissioners may seek to audit the financial records of a sports body by giving notice in writing. Approved sports bodies are also required to submit annual progress reports to the Sports Unit of the Department of Arts, Sport and Tourism. This report should outline work completed on an approved capital project and the timetable for remaining works (if any). It should also list the total donations received under this scheme, with a breakdown of the amounts received from PAYE donors, self-employed donors and corporate donors. This information is then passed to the Revenue Commissioners.

Effects of the Scheme

How Sports Bodies are using the scheme

4.7 It is difficult to put a value on the benefits arising to sports bodies and ultimately the wider community from the existence of such a relief. Sport is generally acknowledged as having a significant role to play as is noted by the Department of Arts, Sports and Tourism –

> "Over the years, sporting organisations and volunteers have formed the backbone of Sport in Ireland. We must build on this legacy to enrich our lives both as active participants and as a country which values vibrant, local community identity and the achievements of our sporting heroes.
>
> Sport and recreation also have other benefits for the nation both economic in terms of sports tourism, employment opportunities through growth in the sector, and social in terms of better physical and mental health and well being.
>
> Sport also has a special part to play in combating the problems of drug abuse, crime and social exclusion, particularly among young people living in areas of social and economic disadvantage.
>
> The development of high performance in Irish sport is another key element within overall national sports strategy. Top performances in the sporting arena, both nationally and internationally, based on a drugs-free philosophy of sport,

provide positive role models as well as enhancing our sense of national achievement, and the image of Ireland overseas."[99]

4.8 Section 847A can be seen as supporting this aim. However, to date it is only a small part of overall support for the sector. Over the years since the introduction of the scheme, the following had been provided under the Sports Capital Programme:

Funding allocations under Sports Capital Programme:

Year	**2002**	**2003**	**2004**	**2005**
Amount	€78.8m	€56.4m	€61.8m	€63.2m

Source: Department of Arts, Sports and Tourism

4.9 While it is still early days for the scheme, the projects approved by the Department of Arts, Sports and Tourism are increasing in value over time and a wide variety of clubs are availing of the relief is also increasing. This can be seen from the following tables:

Year	**Number of Projects Approved**	**Approved Value €**
2002	11	9,421,727
2003	47	40,769,316
2004	40	57,395,428
2005 to end September	31	19,396,483
Total	**129**	**126,982,954**

Types of clubs availing of scheme:

	2002	2003	2004	End Sept. 2005	**Total**
Football	1	5	7	5	18
GAA	6	25	14	13	58
Cricket	0	0	1	0	1
Tennis	0	2	1	3	6
Golf	0	1	2	0	3
Polo	0	0	1	0	1
Rowing/Sailing/Yachting	2	5	2	3	12
Flying	0	0	0	1	1
Rugby	1	6	4	4	15
Swimming	0	1	0	0	1
Basketball	0	0	1	0	1
Athletics	1	1	0	0	2
Other	0	1	7	2	10
Total	**11**	**47**	**40**	**31**	**129**

4.10 Approved sports bodies are required to submit annual progress reports to the Sports Unit of the Department of Arts, Sport and Tourism. This progress report includes details on the total donations received under this scheme, with a breakdown of the amounts received from PAYE donors, self-employed donors and corporate donors. Self assessed and corporate donors claim the tax relief in their tax returns.

[99] Department of Arts, Sports and Tourism, *Sport – Overview*, www.arts-sport-tourism.gov.ie

The sporting bodies can claim the relief in respect of donations from the PAYE sector. By the end of 2004, sports bodies had reported the following to Department of Arts, Sports and Tourism:

	Projects Approved in 2002	**Projects Approved in 2003**	**Projects Approved in 2004**	**Total**
Approved Value of Projects	€9,421,727	€40,769,316	€57,395,428	**€107,586,471**
Number of Approved Projects	11	47	40	**98**
Number of Approved Projects in receipt of Donations at end 2004	10	35	25	**70**
Donations Received from **PAYE** Taxpayers to end 2004	€280,668	€947,893	€475,466	**€1,704,027**
Donations Received from **Self Assessed** Taxpayers to end 2004	€82,275	€808,107	€415,037	**€1,305,419**
Donations Received from **Corporate** Taxpayers to end 2004	€66,800	€5,742,214	€227,152	**€6,036,166**
Total Donations Received by end 2004	**€429,743**	**€7,498,214**	**€1,117,655**	**€9,045,612**

4.11 This data is supplied by the clubs to the Department of Arts, Sports and Tourism and is not directly comparable with the information held by Revenue for a number of reasons. Not all sporting bodies will make a claim to Revenue as some will not receive donations from PAYE taxpayers and also there is often also a delay between when the donation is made and the body makes the claim. The data supplied by the Department of Arts, Sports and Tourism is the total amount of the donation made; the cost to the Exchequer in terms of tax foregone depends on the marginal tax rate of the donor.

4.12 When this scheme was introduced, it was estimated that it would cost €0.7 million in 2002 and €7m in a full year. The Revenue Commissioners estimate that in 2002 the cost to the Exchequer in respect of PAYE Donors was €0.05 million and €0.07 million for the self-assessed sector. The cost, however, is likely to rise as organisations become more aware of the scheme and they in turn inform their donors and encourage them to donate in a tax efficient manner.

- *PAYE*

4.13 The Revenue Commissioners have provided the following table from information extracted from applications for PAYE refunds from approved sports bodies:

Relevant Year **[to which claim for refund refers]**	**No of Approved Sports Bodies who applied for refunds**	**Total amount refunded by Revenue to Approved Sports Bodies**	**Total amount of donations made by PAYE taxpayers**
2002	2	€12,968	€30,024
2003	15	€204,925	€324,499
2004	10	€201,104	€307,620

- *Self Assessed*

4.14 For the self-assessed, Revenue has estimated the following costs for 2002 -

Non-PAYE taxpayer claims to Revenue in 2002:

Range of Gross Income		**Totals**		
From	To	Number of cases	Amount of Donations to Approved Bodies	Reduction in Tax[100]
€	€		€	€
0	25,000	11	13,216	2,283
25,000	50,000	35	38,902	9,401
50,000	75,000	28	52,189	19,950
75,000	100,000	12	24,951	10,479
100,000	150,000	16	35,734	15,008
150,000	200,000	12	32,585	13,686
Over	200,000	22	104,275	43,795
	Total	**136**	**301,852**	**114,602**

Like Section 848A, and as might be expected, the biggest donations come from those with the highest incomes. However, a review of 400 individuals with high incomes by the Revenue Commissioners revealed that, under the scheme, relief on donations to the value of €1,304 was claimed in 2002. However the scheme had just commenced and this figure is likely to rise in future years. Increasing donations from this section of taxpayers is in keeping with the aims of the scheme of encouraging those with high incomes to develop a habit of philanthropy. It must also be remembered that the recipients of this tax relief make no personal gain from their donations. It is a very different scenario than a relief given on investment from which the investor is subsequently going to personally benefit.

- *Companies*

4.15 In the survey of companies undertaken by the Department of Finance (results in table below), out of 53 respondents, 49 did not give money to sports bodies under

[100] Figures have not been ‘grossed up’ to allow for under coverage of tax returns at about 95% in 2002.

Section 847A, two made money available and one company indicated that while they make money available to approved sports bodies they do this through the medium of sponsorship and not under Section 847A. Only one company indicated that the amount they donate to sports bodies has increased as a result of the introduction Section 847A relief. The total amount donated by the two companies making donations in the last year was €2,000. As mentioned previously, donations are a very subjective choice; it is not possible to extrapolate the information received in the survey to the whole corporate sector. While the Department of Finance survey would seem to indicate that the relief is not encouraging donations, evidence received from the Department of Arts, Sports and Tourism would suggest that corporate donations are being received by sports bodies. It is also still early days for the scheme and awareness of it is gradually increasing amongst donors and sports bodies so it is likely that take-up will increase in future years.

Summary Results of survey undertaken by Department of Finance

Response Rate: 53%[101]

Question	Reply
How much of your donations budget goes to approved sports bodies and is tax deductible under the scheme of tax relief for donations to an approved sports body for the funding of approved projects?	Total amount donated by 2 companies = €2,000 Zero or negligible = 49. This includes one company that makes significant donations to sports by way of sponsorship/advertising. One company indicated that they donate to local clubs not participating in the scheme. One company indicated that do not make money available to approved bodies under Section 8484A - contributions are made by way of sponsorship and deducted as a trading expense. Total = 53
Has the amount your company donates to approved sports bodies increased **as a result of** the introduction in 2002 of the scheme of tax relief for donations to an approved sports body for the funding of approved projects?	Yes = 1 No = 51 One company indicated that while they make money available to charities/bodies they do not claim relief under Section 8484A. Instead contributions are made by way of sponsorship and deducted as a trading expense. Total = 53

Potential abuse of the scheme

4.16 Under this scheme no benefit must arise to the donor. The Revenue Commissioners have maintained a tight stance on this and report that there is no evidence of wide scale abuse. They advise that the main issues that have arisen to date include the use or preferential use of the facilities of the club and preferential access to match tickets. These have been held to be a benefit for the purpose of the relief and consequently associated donations have not been deemed eligible. To date,

[101] 52 replies were received but one reply incorporated responses for 2 organisations surveyed.

the only concessions made have been for nominal benefits such as the receipt of a newsletter, printing of a donor's name etc.

4.17 There have been some indications that some clubs were trying to make donations compulsory or replacing the annual subscription with a donation. When encountered these are challenged by Revenue and the relief denied. There was one incident brought to the attention of Revenue in relation to a particular club which intended entering into an arrangement with a developer, whereby the developer of a housing project (who is obliged under planning laws to set aside land for recreational purposes) would make a substantial donation to the club, and claim for relief under Section 847A and the club would subsequently use the donation to purchase the site from the developer. This was challenged on the basis that the donation would not qualify for relief because of the provisions of Section 847A (5)(g).[102]

4.18 It is recommended that vigilance should be maintained and Revenue should continue to monitor usage of this scheme to ensure abuse does not take place.

[102] A donation shall satisfy the requirements of this subsection if it is not conditional on or associated with, or part of an arrangement involving, the acquisition of property by the approved sports body, otherwise than by way of gift, from the donor of a person connected with the donor. TCA 1997, Section 847A, (5)(g).

5. Options for Changing and Improving the Schemes

5.1 The schemes should aim to be coherent and consistent, efficient for charities, donors and the Revenue Commissioners while avoiding scope for exploitation for tax avoidance purposes.

While these schemes are still relatively new, a number of issues can be pointed to for further consideration –

Should the Schemes be retained?

5.2 These schemes are still relatively new and awareness of them is still increasing. Data is still coming on-stream regarding the cost and take-up of the schemes. Consequently, it is too early to make a decision on the future of these schemes. Certainly, there appears to be significant deadweight in the area; in particular, companies do not seem to be strongly influenced by the existence of the schemes. Of the fifty-three replies received to the Department of Finance survey, forty-three had not increased the amount they donate to charities and approved bodies as a result of the introduction of Section 848A and fifty-one had not increased the amount they donate to sports bodies as a result of the introduction of Section 847A. This to a certain extent can be explained by the fact that corporation tax rates are low so companies do not have an overriding incentive to reduce their tax bill. Therefore, donations are made for other reasons. Also in the absence of Sections 848A and 847A, companies could continue to make money available to the charities and approved bodies and also claim tax relief through the medium of sponsorship and advertising.

In the case of individual donors, it is likely that many of the donations to charities and approved bodies, including sports bodies, would have occurred with or without the availability of tax relief. It takes time to change habits – the aim is that the relief will encourage donors to give in a more planned way and also increase the value of their donation. Over the next few years, data on the number of donors, the size and destination of the donation etc. should indicate if there is more activity in the area and this should allow for stronger conclusions to be reached on whether the reliefs are prompting donors to give.

Even if it is accepted that there is significant deadweight in the scheme, there is nevertheless an argument that the government should be supporting the work of charities and other approved bodies, including sports, through the tax or grant systems, or both. The advantage of tax reliefs over grants is that it allows individuals rather than government make choices relating to which charities or bodies receive government support. It should also be borne in mind that tax relief on donations encourages philanthropy from which wider society benefits. The recipient of a tax relief for donations makes no personal gain from the donation and therefore it is a very different scenario than a relief given on investment from which the investor is subsequently going to personally benefit.

The tax relief should be retained in its present structure for the moment. It should be reviewed again at a later stage as more data becomes available about its use and cost.

Tax Equity

In reviewing any scheme, it is necessary to look at the issue of equity.

5.3 *Treatment of PAYE and self-assessed donors*

There is a perception that self-assessed taxpayers obtain the benefit from the scheme whereas in the case of PAYE taxpayers it is the charity or body, including sports bodies, which gets the benefit. The Conference of Heads of Irish Universities (CHIU) suggested that the scheme would be more attractive if a tangible tax break was given to PAYE donors so that they could see the benefit to themselves of making a donation. The CHIU suggested that this would potentially increase the level of donations from this sector.

In addition, the Revenue Commissioners have indicated concern that in administering the schemes discrepancies occur when approved bodies inadvertently include self-assessed donors in their PAYE refund claims. In 2004 selective checks on claims lead to PAYE refund claims being restricted by over €1m because of this.

There is an argument that both kinds of taxpayer should be treated using the same methodology. Possible options in this context are:

I. give the PAYE donor the same tax treatment as the self-assessed donor, that is to allow the PAYE taxpayer claim the relief rather than the charity or approved body. This could work along the lines of the way taxpayers claim for relief for medical expenses. Such a system would increase the administrative burden for the Revenue Commissioners and it could potentially result in reduced revenue to charities as PAYE donors may continue to give the same amount but the charities would lose out on the refund.

II. give the self-assessed donor the same tax treatment as the PAYE donor, that is allow charities and approved bodies, including sports bodies, recover the tax from Revenue in respect of donations from both self-assessed and PAYE donors. The Revenue Commissioners favour this approach. They note that this would make it easier to administer the system, would be more equitable and would provide more accurate and timely data. At this stage it is not proposed to make such a change. Based on current scheme costs, the additional charge to the Exchequer arising from this change in relief treatment is estimated at €1.5m annually, arising from 'grossing up' the tax relief in the case of self-assessed donors. It is also possible that some self-assessed donors are not claiming the relief but if the system was changed the charity would make the claim and the cost would impact on the Exchequer. Technical difficulties would arise with this approach. The marginal rate of tax for a self assessed individual only becomes clear when their tax return is submitted and it is possible that the refund could be claimed by the charity or approved body before the donor's tax is actually paid to Revenue and hence more could be refunded than is actually paid by the taxpayer. The Revenue Commissioners have suggested that it would be possible to overcome this issue through a combination of assessing the previous year's tax records for the donors in question together with the reasonable assumption that if they were in a position to make a donation of the amount claimed, that their circumstances have not altered, and requiring self assessed donors to submit a declaration that they expect to pay tax of at least the order of the donation when their tax return is lodged. This would also be accompanied by an annual programme of 'look-back' audits. However, bearing all this in mind, consideration has to be given to the possibility that charities could lose out as a result of a change in the system. If the self-assessed sector no longer personally get the relief they might find the scheme less attractive and hence reduce the amount they donate. International evidence, in particular from the US, suggests that allowing a donor to personally claim the tax relief is as an important factor in the encouraging donations (see Appendix 1).

The system whereby PAYE and self assessed taxpayers are administered differently appears to be working – certainly both categories of taxpayer are availing of the scheme. As knowledge of the scheme increases it is likely that taxpayers will become even more aware of the tax implications of giving and they will calculate their donation accordingly. For example, a donor on self-assessment will make a donation in the knowledge that they are getting a deduction and so maximise their contribution. As knowledge of the scheme increases over time taxpayers will likely become more aware of the tax implications of giving and calculate their donation accordingly. Also, a PAYE taxpayer on the higher tax rate will realise that if he wants a university to receive €1,000, he has to donate €580 from his after-tax income and the subsequent refund from Revenue will increase the value of the donation by €420.[103] As a data trend becomes available over time this will show in more detail how the two categories of taxpayer are responding to the relief. Bearing these arguments in mind, it would be best to leave the relief as it is for the moment.

If evidence at a later stage suggests that the PAYE taxpayer would favourably respond to personally (rather than the receiving body) receiving the tax relief, consideration could be given to the introduction of a payroll scheme along the lines of that in existence in the UK. However, further research would need to be done in this area to firstly determine if it is necessary and also to consider the compliance costs for employers and the administrative costs for the Revenue Commissioners.

Eligible charities and approved bodies have a role to play in countering the problem whereby they include self-assessed donors in their PAYE refund claims. Groups should explain to their donors at the time that the donation is being made that different methodologies exist in the treatment of self-assessed and PAYE taxpayers. All donors should be in a position to determine whether they fit into the PAYE or self assessed category. To further increase awareness, Revenue could be asked to make eligible charities and bodies more familiar with the different methodologies for treating self-assessed and PAYE taxpayers.

5.4 *Differing de minimis for PAYE and Self-Assessed Sectors*

To be afforded the relief, the legislation requires a minimum donation of €250. However, in the case of a donation from a PAYE taxpayer the body claims the refund from Revenue and hence the donation can be worth varying amounts - €250 if the donor is not paying tax, €312.50 for standard rate taxpayer or €431 for a top rate taxpayer. If the donor is a self-assessed taxpayer or a company the approved body gets €250 and the donor is allowed deduct for the relevant amount of tax, which for a

[103] The tax refund to the charity or body is calculated as follows: Amount of Gift * (marginal rate of income tax)/(100-marginal rate of income tax).

self-assessed taxpayer on the top rate is €105. This situation leads to differing treatments for different taxpayers, as in effect it provides a higher *de minimis* limit for PAYE taxpayers compared with others.

A possible solution would be to introduce varying thresholds for PAYE workers - €145 for those on the top tax rate, €200 for those paying at the standard rate and €250 for those not paying tax. Thus, with the tax refund this would bring the donation up to €250. This would be complex to operate and charities and approved bodies could lose out as taxpayers reduce the amount they donate to the minimum allowable for tax relief purposes.

An alternative would be to introduce a higher threshold for the self assessed sector depending on an individual's tax rate. This would also be a complicated system and it assumes that a taxpayer would be aware of their rate at the time of making their donation, which is often not the case.

Adopting either of these options would not be ideal. It could complicate the schemes which could in turn lead to taxpayers avoiding them. It could also reduce the amounts being donated. Bearing this in mind and as the intention was to introduce a simple and straightforward scheme this anomaly should be tolerated and no changes made in this area.

5.5 *Encourage higher donations*

The CHIU proposed that Section 848A should be altered to encourage larger donations, suggesting perhaps a higher relief for donations above a certain threshold. This however would raise issues of tax equity and would be seen to be favouring individuals with high incomes who are obviously in a better position to make larger donations. Also the relief is currently given at a donor's marginal tax rate, to give relief higher than that could lead the relief being granted above the top rate of income tax.

<u>Altering the scheme</u>

5.6 *Non-cash items*

The Irish Charity Tax Reform Group and the Conference of Heads of Irish Universities suggested that the scheme be extended to cover gifts of non-cash assets including property, shares and securities. To support their argument they pointed to the UK and US where such relief is available (see Appendix 2).

The rationale behind Sections 847A and 848A is that tax relief is given against income based on the assumption that the relevant donation is coming out of the donor's income. To give income tax relief for the donation of non-cash items would break this link and could be seen as a request for the Exchequer to give a subsidy to charities and approved bodies. Currently for Capital Gains Tax (CGT) purposes, where an asset is donated to an eligible charity the donation is deemed to be such that neither a gain nor a loss accrues to the donor on the disposal. Therefore, no tax charge arises in respect of such a donation and any gain on a subsequent disposal of the asset by the charity is not a chargeable gain provided it is applied for charitable purposes only. Income tax relief on the value of an asset donated together with the current CGT exemption, would amount to a double relief. Such a concession could result in tax relief being granted beyond the top rate of income tax.

There would also be significant difficulties for the Revenue Commissioners in valuing non-cash donations. The New Zealand government considered this issue in 2001 and concluded –

> 'To allow this would lead to increased compliance costs for taxpayers, and administrative costs for Inland Revenue, as it would give rise to questions as to the valuation of the donated goods and services. When rebates are available for non-cash donations, complex valuation rules are required, and anecdotal evidence from other jurisdictions suggests this can give rise to tax planning opportunities.'[104]

Extending the scheme to non-cash items would likely increase the incentive for donors to donate to charities and approved bodies. In particular, high net worth individuals on self-assessment would be incentivised as they would possibly be gaining relief beyond the top rate of income tax. However, even taking this consideration into account, the above arguments lead to the conclusion that the relief should not be extended to non-cash donations.

5.7 *Altering the €250 donation threshold*

The €250 threshold means that donations under this amount are not eligible to claim the relief. The threshold provides donors with an incentive to pitch their donation at at least that level so as to benefit from tax relief. It also reduces the administrative burden for the Revenue Commissioners.

During the public consultation process, the Irish Charities Tax Reform Group proposed that the threshold should be reduced to €100 to allow smaller charities to benefit from the scheme as on average they receive donations of €60-€150 per annum from core supporters. The CHIU also suggested that the threshold should be removed or reduced. Research submitted to the Department of Finance by the Irish Charities Tax Research Group indicated that reducing the threshold would increase the amount refunded to charities and approved bodies and would increase the number of such organisations benefiting from the relief. However, this research also indicated that a reduction in the threshold would give rise to substantial Exchequer costs and there would be significant deadweight costs involved.

A reduction in the minimum donation would have the effect of increasing the numbers of donations qualifying for relief and hence increase costs to the Exchequer. It would also lead to an additional workload for the Revenue Commissioners. By way of illustration, Revenue has estimated that if the threshold for Section 848A was lowered to €100 and consequently another 30,000 PAYE donors made an eligible donation of €100 the additional cost to the Exchequer would be about €1.9m. Revenue also estimated that if 6,000 additional self assessed donors made eligible donations of €100 the additional Exchequer cost would be in the region of €0.2m.

The argument for reducing the threshold can be justified on the rationale that it would serve the purpose of increasing the tax relief given to charities as they would be able

[104] Inland Revenue, New Zealand (2001), *Tax and Charities – a government discussion document on taxation issues relating to charities and non-profit bodies*, www.taxpolicy.ird.govt.nz, p. 50.

to claim relief on donations below €250. However, it is not certain that a reduction in the relief would lead to a change in behaviour and a consequent increase in donations. It could be the case that charities would receive the same level of donations and there would be a significant deadweight cost to the Exchequer. In the UK's equivalent scheme, Gift Aid, the overall level of donations under the scheme is gradually increasing as more charities convert their donors to planned givers. However, according to the UK Treasury when the £250 floor in the scheme was abolished, anecdotal evidence from charities suggested that the immediate impact was that a number of donors began to give amounts below the £250 level, perhaps splitting what they had previously given to one charity between two (see Appendix 2).

In conclusion, the €250 threshold is serving its purpose – it is encouraging donors to make significant contributions to charities and approved bodies, including sports bodies, and it is keeping the administrative burden for Revenue at a manageable level. The purpose of the scheme is to increase donations, not simply to top-up existing donations. Further research is needed into the behaviour of donors in order to determine if reducing the threshold would lead to greater donations, it could just lead to existing donations becoming eligible for tax relief at a significant deadweight cost to the Exchequer. Also, as the threshold has not increased in line with inflation, this means that its real value is gradually being eroded and more donations, assuming they remain in line with inflation, should become eligible for tax relief.

The threshold should be kept under review but it should be retained at its current level for the moment.

5.8 *Ensuring a benefit is not conferred on donors*

To be eligible for tax relief, a donation must 'not confer any benefit on the donor or any person connected with the donor'. This condition is included to ensure that donations are genuine and are not used as a substitute for fees etc. However, the Revenue Commissioners have indicated that this issue may need to be considered further and they intend to draw up guidelines on this issue, especially to clarify areas such as the following -

- how to distinguish between voluntary contributions and compulsory fees in schools, clubs etc;
- does a benefit arise to participants/donors in charity fundraising drives, such as sponsored walks abroad, golf classics etc?;
- is there a benefit arising to the donor if the receiving organisation display a poster advertising of a donor's products or services or if a plaque is erected in the donor' name etc?

To date, Revenue has maintained a tight stance that donations must be at arms length and no benefit whatsoever may attach. In many ways it is even more difficult with Section 847A to determine if there is a benefit accruing to the donor as often the donor is a member of the club to which he/she is donating. To date, the only concessions allowed by Revenue are nominal benefits such as receipt of a newsletter, printing of a donor's name etc.

In the UK, their donations scheme provides for a sliding scale of allowable benefit to donors on donations made by them.[105] This, however, adds to the complexity of the scheme.

The Revenue Commissioners have pointed out that while PAYE donors submit a certificate to the charity or body to which they are donating stating that neither they nor any person connected with them have received or will receive a benefit arising from their donation, there is no requirement for self-assessed donors to make a similar declaration. To protect the integrity of the schemes, consideration should be given to requiring the self-assessed to also submit this certificate.

5.9 *Abolish the two year limit?*

Under Section 848A a charity can apply for authorisation as an eligible charity after it has been granted exemption from tax by the Revenue Commissioners for a period of not less than two years. It has come to the Department of Finance's attention that it is common in the wake of disasters for people to set up a charitable trust specifically to provide relief to victims of the disaster. As a consequence of the two year rule, donations to such trusts do not attract tax relief for two years. However, it is likely that the bulk of donations in such circumstances would go to organisations who have qualified for tax relief, for example to organisations such as the Irish Red Cross and Concern in the case of the recent tsunami.

In the absence of any rigorous regulatory regime for charities, to remove the two-year limit would remove the safeguard whereby charitable organisations must be able to demonstrate a proven track record before they can avail of the donation relief.

5.10 *Other suggestions:*

The CHIU also made the following suggestions to improve the scheme of Tax Relief for Donations to Eligible Charities and other Approved Bodies -

- 'The removal of the fact that a board member or anyone directly related to the charity or approved body can only donate up to 10% of his/her annual income in a tax effective manner' - this limit was introduced to prevent the relief being used in ways other than was originally intended and there is no evidence that charities or approved bodies are suffering by its existence.
- 'Introduction of incentives whereby if one wills property to a charity or approved body probate or any other tax payable would be reduced' –Budget 2001 abolished probate tax in respect of deaths on or after 6 December 2000. Where assets pass on death there is no charge to Capital Gains Tax. Gifts for public or charitable purposes are exempt from Capital Acquisitions Tax

Administering the scheme

5.11 *Improving data*

A government decision to provide relief to a certain sector in society can be regarded as similar to a government expenditure decision. To cost this relief and to judge its effectiveness over time, accurate and detailed information is required. Revenue is the obvious and current source of information on the scheme. Data on the PAYE and the

[105] For further details, see www.hmrc.gov.uk/charities/chapter_3.pdf

self-assessed sectors is either available or coming on-stream. However there is gap with regard to data on the corporate sector.

Under Section 847A, sports bodies provide detailed information to the Department of Arts, Sports and Tourism regarding the amount of donations received from PAYE, self assessed and corporate donors. Currently there is no feasible mechanism in place that would facilitate a comparison between these figures and the amounts claimed by self assessed taxpayer and companies for donations. Generally, it would be useful if such a system could be developed to improve our knowledge of how this scheme is being used and who is benefiting.

In general, efforts should continue to improve data with regard to the amount and destination of donations by all categories of donor.

5.12 *Simplify the administrative procedure for charities and approved bodies*

Each year, participating charities and approved bodies have to request their donors to complete a form outlining their tax details so the charities in turn can submit to Revenue the tax details for their donations. They have at times complained that this is cumbersome and appears to be a waste of time for long-standing donors. However, it is a necessary side effect of granting the relief at the donor's marginal tax rate, as the tax status of individual donors can vary from year to year. One way if solving the problem would be to standard rate the relief but this would have implications for the amount of tax relief received by charities and approved bodies.

5.13 *Informing taxpayers of their status*

Discrepancies occur when charities and approved bodies inadvertently include self-assessed donors in their PAYE refund claims to Revenue. In this event, Revenue notifies the claiming charity and advises them to issue a receipt to the donor in question to allow the donor claim the relief in their own tax return. Consideration could be given to altering this practice so that Revenue also informs the taxpayer that they are entitled to claim the relief. On this issue, however, the Revenue Commissioners have pointed out they do not have the resources to cope with the administrative burden that would arise from the adoption of this practice.

5.14 *Wider promotion of the scheme to donors*

Donoghue et al (2000) noted that a stimulus to encourage donations can come in two forms – from the government through tax incentives or from voluntary organisations 'asking' and highlighting their cause.[106] More should be done to publicise these schemes. This was a point that was also made by the CHIU.

At the introduction of the scheme all approved bodies, including charities and schools, were circulated with information on the scheme. However, it is likely that many donors, and possible charities, are still unaware of the scheme. Research in the UK has indicated that despite a widespread campaign to increase awareness of tax efficient giving, donor awareness remains low. Gift Aid donors in the UK said that while the availability of the tax relief did not influence the amount they gave, they opted to donate in this way because extra money reached their favoured charity or

[106] Donoghue, F, H. Ruddle and R. Mulvhill. (2000), *Warm Glow in a Cool Climate? Philanthropy in Ireland*, Paper presented to conference of International Society for Third Sector Research, Trinity College Dublin, p. 10.

simply because a charity asked them to (see Appendix 1).[107] Bearing this in mind, charities should increase their efforts to make existing and potential donors aware of the scheme. Emphasis should be placed on the positive effects arising from the use of the relief and emphasising the simplicity of availing of the relief. Giving clear information to both PAYE and self-assessed donors to enable them to understand the benefits of the incentives will prompt future use from which charities and approved bodies will ultimately benefit.

Cost to the Exchequer

If the aim was to save money for the Exchequer, the following options could be considered –

5.15 *Restricting the relief to standard rate of income tax for PAYE and self-assessed donors:*

There are two ways of doing this. Firstly, the structure of claiming the relief could be retained but the relief could be restricted to the standard rate of income tax. This would bring it into line with other reliefs, e.g. mortgage interest relief, relief on service charges, relief on tuition fees etc. This however would lead to less money going to charities and approved bodies in the form of PAYE refunds. Further research would be required to determine the effect of such a move on the amount given to organisations, in particular by the self-assessed sector. A second option would be allow the charities and approved bodies claim refunds for both PAYE and self assessed donors on a grossed up basis but at the standard rate. Again further research would be needed to determine what the net effect would be.

Revenue has calculated that the €14.8m charge for PAYE donors in 2004 would have been reduced by about €7m if the relief was given at the standard rate of tax (20%). By way of illustration, the Revenue Commissioners have examined year 2004 repayments in respect of PAYE donations the case of four Religious Orders and four other major charities with a view to determining what the effect would be of restricting the relief to the standard rate. The results are shown in the following table-

Sample 1: 4 Religious Orders		
Actual 2004 repayment	€0.5m	
Repayment if relief was standard rated	€0.3m	
→ Reduction on average		36%
Sample 2: 4 Charities		
Actual 2004 repayment	€2.4m	
Repayment if relief was standard rate		€1.1m
→ Reduction on average		45%

[107] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, pp. 5-6.

5.16 *Limit the size of the donation that can attract tax relief.*

The potential exposure of the Exchequer is significant with no limit to the size of donation that can attract relief where there is no association between the donor and the body to whom the donation is made. Of course, the ability to claim the relief is dependent on tax being paid to cover the amount being reclaimed. Consideration could be given to placing a cap on the size of donation eligible for tax relief e.g. 10% of income. In the United States, the amount of deduction that can be claimed is limited to 50% of the donor's adjusted gross income.[108] In New Zealand, the maximum rebate that can be claimed is $630 for donations of $1,890 or more, if a claim is made for less than the maximum the donor receives a third of the total amount as a rebate.[109] In Canada, an individual is entitled to claim part of all of the eligible amounts of their gift, up to the limit of 75% of net income for the year. This limit can be increased for gifts of capital property.[110] (See Appendix 2.)

To date the only experience in Ireland has been the effect of the 10% income cap on relief introduced in the 2003 Finance Act. This was largely targeted at members of religious orders but their situation is not altogether analogous with the norm, their full after-tax salaries/pensions were being donated to their orders whereas to date this has not been the case with lay donors to charities and approved bodies. Evidence to date does not suggest that the Exchequer is unduly exposed at present. This position should continue to be monitored but no action is required at present.

[108] Internal Revenue Services, *Publication 526 – Charitable Contributions*, www.irs.gov

[109] Inland Revenue, *Individual Income Tax - Donations, childcare and housekeeper rebates,* www.ird.govt.nz

[110] Canada Revenue Agency (2004), *P113 – Gifts and Income Tax*, www.cra-arc.gc.ca

6. Conclusions

6.1 It is too early to assess the significance of Section 848A and 847A in improving the financial situation of charities and approved bodies, including sports bodies, through raising funds from taxpayers and also its effect in changing attitudes and behaviour with regard to donating. As a result the following conclusions can be reached at the moment.

6.2 *Retain structure as is*
These schemes are still relatively new and while it is possible to say that the numbers using the schemes are increasing, that is not the same thing as saying that the schemes have been influential in increasing donations. Currently, organisations are still working to make their donors aware of the existence of the scheme and time should be allowed for the structure as it exists to become established. These schemes need to be kept under review. In time, a data series will show how donors and bodies are using the schemes and this in turn will provide baseline data against which to judge any future changes.

6.3 *Improve data*
Accurate, timely and comprehensive data is essential for evaluating the effects of any public policy. Without data indicating the level of donations before the schemes' introduction it is difficult to determine if they have been effective in encouraging donations. Efforts should be made to improve the data for these schemes so information is available with regard to the overall cost of schemes. The cost should also be broken down for the three types of taxpayer - PAYE, self-assessed and corporate. Information is also needed on what groups are benefiting from the donations from the three types of taxpayers. Such data will allow a trend to be seen over time which will improve knowledge on the existing schemes and will also allow for the effects of any future changes to the schemes to be assessed.

6.4 *Cash donations only*
Relief should continue to be given for donations of cash only. To provide income tax relief on top of existing reliefs for the donation of non-cash items to charities and approved bodies would amount to a double relief. There would also be difficulties in valuing such assets.

6.5 *Monitor to ensure the schemes are not abused*
To date, the Revenue Commissioner's experience has been that charities and approved bodies, including sports bodies, have used the schemes in the spirit with which they were intended. Vigilance should be maintained and Revenue should continue to monitor usage to ensure abuse does not take place.

6.6 *Promotion of scheme*
Uptake of the schemes, while increasing, could be increased further. Charities and approved bodies should promote the scheme more widely to make donors more aware of it.

Appendix B.1: Justification for the donations schemes

The Second Report of the Commission on Taxation on Income Tax Incentives, published in 1984, noted that:

> '… it is not sufficient to show that the activity at which the incentive is directed is worthy and would benefit. If this criterion were accepted to justify incentives, virtually all items would qualify for incentives … because there is almost no activity which cannot be shown to benefit from a selective reduction in taxation.'[111]

Generally, the case for tax-relief for charitable donation is typically that charities provide goods and services that are deserving of government support. In economic terms, the work carried out by charities and other approved bodies share some of the characteristics of pure public goods or services or goods that are essentially private but have positive externalities or spill-over effects, such as medical research or education.[112] With these types of goods and services, there is not a direct link between what people pay and the benefits they receive. There is a danger that individuals will 'free-ride' on the contributions of others, with the consequence that the goods or service are either not supplied by the market, or if supplied, will be supplied in insufficient quantity. Hence, there is an argument for government intervention to assist such groups in carrying out their work, but not specifically by providing tax relief.

Encouraging individuals to give more and encouraging more individuals to give are both ways to increase charities' incomes. As well as increasing charities' total income, a further aim of a tax relief may be to encourage a society in which individuals interact with charities. Granting tax relief, rather than handing out grants, allows individuals rather than the government to decide which charities should get government money (and relieves the government of an administrative burden).[113] However, a consequence of this may be that support is biased towards the charitable purposes chosen by higher income earners, and the government has no control over the aggregate amount of support it provides.

As recently noted in a report commissioned by Revenue and Customs in the UK, 'classical economic theory is ill-equipped to account for philanthropy because it focuses on self-interested market exchanges and utility maximisation.'[114] However, attempts can be made to provide a rationale. One of the main reasons for preferring

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[111] Second Report of the Commission on Taxation, Direct Taxation: The Role of Incentives, p. 18

[112] Externalities are an economic side-effect. They are costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity and these costs and benefits are not reflected fully in prices. For instance, smoke from a factory may impose clean-up costs on nearby residents; bees kept to produce honey may pollinate plants belonging to a nearby farmer thus boosting his crop. Because these costs and benefits do not form part of the calculations of the people deciding whether to go ahead with the economic activity they are a form of market failure, since the amount of the activity carried out if left to the free market will be an inefficient use of resources. If the externality is beneficial, the market will provide too little; if it is a cost, the market will supply too much.

[113] Banks, James and Sarah Tanner (1998), *Taxing Charitable Giving*, Institute of Fiscal Studies, p. 1.

[114] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, p. 8.

tax concessions over direct expenditure as a way of increasing private donations has to do with the net revenue effect of offering a concession. According to Banks and Tanner (1998), the effect of tax relief is to lower the perceived 'price' of giving to charity. 'If the price of something falls, economics predicts that, other things being equal, its consumption will rise. This is both because it is cheaper relative to other goods (the 'substitution effect') and because consumers' real disposable income will increase, allowing them to afford more of all goods (the 'income effect'). Assuming that donations are like other goods, when the price of giving goes down, it makes sense to donate more (and substitute away from other goods and services), since giving is now a relatively cheaper way of getting utility or increasing well-being. So the effect of introducing (or broadening) tax relief on donations will be to increase the level of donations. By this argument, tax relief is more effective than grants at increasing charities' incomes because individuals' donations increase by more than enough to offset any fall in grants.'[115]

However, as noted in a study by the Canadian Policy Research Network, such economic models are founded on the presumption that individuals make decisions in order to maximise utility. 'If individuals make contributions to charities and they derive satisfaction from doing so, they will take into account this satisfaction along with the satisfaction they obtain from consuming other goods, when making their decisions about which goods to consume and how much to consume or donate. In addition to the private satisfaction that a donor gets when making a gift to charity, there are also external benefits attached to the gift since the funds are used to provide a socially valuable good or service, but the individual donor will only take these benefits into account insofar as they affect the personal satisfaction derived from the donation. When making their choices, individuals are also constrained by their budgets – i.e., they cannot purchase goods or services that have a value in excess of their net-of-tax income. The latter will in turn be affected by income taxes and tax concessions given to donations. Hence, an optimising consumer will choose to make donations so that, at the margin, the satisfaction derived from making the donation relative to the satisfaction obtained from consuming a private good is exactly equal to the net of tax cost of the donation'.[116] Therefore, tax concessions that reduce the net-of-tax price of giving will provide an incentive to individuals to increase their giving relative to their consumption of other goods. However, it is not clear that donations are a substitute for other goods and services - donors may decide on the level of donation on the grounds of a perceived level of need or of a belief in an appropriate level of provision of charitable goods and services.[117]

Ultimately, investigation of the effect of tax relief on individual donations is an empirical matter. The key is the responsiveness of donors to a change in the perceived price of donations. Donors may react to the introduction of a tax relief by increasing their donations or they may reduce their net donation to offset the relief given by the government. This is a concept referred to as the 'price elasticity of giving' – the percentage change on the level of donations resulting from a 1 per cent change in the price. For example, an elasticity of -1 says that a one percentage point tax break on donations yields one per cent in donations: in this case the effect on

[115] Banks, James and Sarah Tanner (1998), Taxing Charitable Giving, Institute of Fiscal Studies, p. 8.
[116] Scharf, Kimberly, Ben Cherniavsky and Roy Hogg (1997), *Tax Incentives for Charities in Canada,* CPRN Working Paper, CPRN 03, p.8.
[117] Banks, James and Sarah Tanner (1998), Taxing Charitable Giving, Institute of Fiscal Studies, p. 8-9.

revenue is the same whether the government transferred money to the charity or gave the tax break. On the other hand, an elasticity of greater than one in absolute value implies that the loss in tax will be more than offset by increased donations as a one percentage point tax break will increase donations by more than one percent. The Canadian report, mentioned above, notes that several empirical studies have been carried out in the US to estimate the price elasticity of giving. For the most part, these studies have estimated the price to be greater than one in absolute value.[118]

It is not possible to work out elasticities in Ireland as there is not sufficient data available on current individual or corporate donations or on the level of donations prior to the introduction of the relief. If the scheme is being altered in the future, it would be useful if baseline data was gathered to allow analysis of subsequent behavioural patterns.

Individual support for charities and approved bodies

People give money to charity in a variety of ways including through collecting tins, raffle tickets, sponsorships, buying charity goods etc. This type of giving is for the most part spontaneous. Section 848A was designed to encourage donors to develop the habit of giving in a planned way.

Research published by the John Hopkins Institute ranked Ireland eighth of thirty four countries survey in terms of giving – measured in terms of giving including cash or in-kind gifts by individuals, corporations or foundations - as a percentage of GDP over the period 1995-2000 (see table below).[119]

Private Philanthropy as a percentage of GDP, ca. 1995-2000[120]

Rank	**Country**	**Giving as % GDP, ca. 1995-2000**
1	Israel	1.29%
2	United States	1.01%
4	Spain	0.87%
5	United Kingdom	0.62%
8	Ireland	0.55%

A survey carried out in 1999 indicated that 84% of respondents gave to charity and that, in total, they supported the voluntary sector to the tune of €305m (£240.5m). Donoghue et al (2000) concluded there was room for improvement because as Ireland became richer, individuals with more money to spend were not necessarily spending that money on charities. They also argued, however, that donations to third world charities had increased in the aftermath of the introduction of the tax relief for such donations. This in turn led them to call for the introduction of further tax incentives.[121]

[118] Scharf, Kimberly, Ben Cherniavsky and Roy Hogg (1997), *Tax Incentives for Charities in Canada,* CPRN Working Paper, NO. CPRN 03, p. 12.

[119] Donoghue, F., Anheier, H. and Salmamon, L., *Uncovering the Nonprofit Sector in Ireland - Its Economic Value and Significance,* John Hopkins Comparative Nonprofit Sector Project, National College of Ireland, 1999, p.32.

[120] John Hopkins Institute, *Comparative Data Tables*, www.jhu.edu

[121] Donoghue, F, H. Ruddle and R. Mulvhill. (2000), *Warm Glow in a Cool Climate? Philanthropy in Ireland*, Paper presented to conference of International Society for Third Sector Research, Trinity College Dublin, p. 3-9.

Corporate support for charities and approved bodies

Research into corporate donations by Donoghue (2000) estimated that in 1997 Irish corporations donated a total of €15m (£11.8m) to the voluntary non-profit sector. This comprised €13.3m (£10.5m) in cash and €1.7m (£1.3m) in in-kind or non-cash support. [122] Donoghue et al (2000) concluded that corporate donations in Ireland lagged behind the US and the UK and 'are probably in need of some type of stimulus to boost activity'.[123]

Total Amount of Support to Non-Profit Sector in 1997 by Corporates[124]

	Cash (€m)	%
Sports	3.4	25
Community Development	2.5	19
Education	2.0	15
Other	1.5	11
Health	1.4	11
Social Services	1.2	9
Arts	1.1	8
Overseas	0.3	2
TOTAL	13.3*	100

** discrepancy due to rounding*

Companies make donations for a variety of reasons. Donoghue (2000) found that advertising was the main reason for making a donation and tax considerations were not a big factor in the decision to donate (see table below). Donoghue noted there is a high correlation between a company's advertising and its philanthropy because the image of a company is said to improve through supporting charitable causes. This is based on the assumption that if a company can afford to engage in corporate support, it must be profitable and successful. Companies with greater public contact, such as financial, retail and food companies engage in greater levels of corporate support.[125]

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[122] Donoghue, Freda (2000), *Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland*, National College of Ireland, p. 40.

[123] [123] Donoghue, F, H. Ruddle and R. Mulvhill. (2000), *Warm Glow in a Cool Climate? Philanthropy in Ireland*, Paper presented to conference of International Society for Third Sector Research, Trinity College Dublin, p. 4.

[124] Donoghue, Freda (2000), Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland, National College of Ireland, p.15.

[125] Survey of top 1,000 companies and a 26% response rate. Donoghue, Freda (2000), *Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland*, National College of Ireland, p. 9.

Benefits of Corporate Support[126]

Benefit	Number	%
Advertising	94	48.5
Community improvement/development	49	25.3
Very few or no benefits	36	18.6
Positive employee morale	35	18.0
Goodwill	29	14.9
Good corporate citizenship	28	14.9
Feelgood factor	23	11.9
Mutuality of benefit	19	10.3
Tax effective in some cases	4	2.1
Each case is unique	1	0.5
Education	1	0.5

In Donoghue's survey, half of the respondents thought that current government incentives were insufficient, when asked what the government could do to encourage corporate support, almost two-thirds of respondents requested more tax relief. Both actual and potential corporate donors also thought that there was an onus on voluntary organisations to do something to improve their own chances of success in acquiring corporate support.[127]

Why introduce a tax relief?

A government discussion paper produced for the New Zealand government in 2001 noted –

> "Subsidising charities enables governments to further their social objectives, including by means of increasing support to disadvantaged members of society. One of the reasons governments provide subsidies to the private sector rather than simply increasing state provision is that it can result in a better targeting of resources. The donations people make to a charity provide an effective indicator to the extra goods and services people feel are needed. Subsidising charities also ensures that those members of society who do not donate to charity but who nevertheless benefit indirectly from charities are contributing through their general tax payments."[128]

Such subsidisation can take the form of exempting charities income from tax and/or providing tax relief on donations to such organisations. This discussion paper also points out that there are however a number of issues that governments need to take into account when using the tax system to provide support for charities and approved bodies, namely - [129]

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[126] Survey of top 1,000 companies with a 26% response rate. Donoghue, Freda (2000), *Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland*, National College of Ireland, p. 28.

[127] Donoghue, Freda (2000), *Philanthropy or Advertising? Corporate Giving to the Non-Profit Sector in Ireland*, National College of Ireland, p. 35.

[128] Inland Revenue, New Zealand (2001), *Tax and Charities – a government discussion document on taxation issues relating to charities and non-profit bodies*, www.taxpolicy.ird.govt.nz, p. 6.

[129] Inland Revenue, New Zealand (2001), *Tax and Charities – a government discussion document on taxation issues relating to charities and non-profit bodies*, www.taxpolicy.ird.govt.nz, p. 7.

- In granting tax concessions, governments forgo tax revenues which means that governments need to raise money from other sources.
- Government subsidy by way of a tax exemption can encourage growth in inefficient ways – while the subsidy may result in more output of a particular good or service, the resources redirected to the subsidised activity to produce the extra output might have been used to greater effect in another activity, leading to a net loss to society from a subsidy.
- A subsidy through the tax system is not subject to direct control by the government.
- Assistance through the tax system is not transparent and, as such, disguises the total level of government expenditure on the area.

A government must take these issues into account when considering the case for introducing – or extending – tax relief for charities and approved bodies. As Banks and Tanner (1998) noted a case can be made for tax relief when one or more of the following conditions hold –

- If tax reliefs have a big positive effect on individual donations.
- If the government wants to let individuals decide to which charities revenue should be allocated.
- If the government wants to commit more resources to the charitable sector in aggregate, holding government grants constant.
- If there are strong non-economic arguments, such as wanting to avoid potentially controversial grant-making decisions, believing that people react positively to tax reliefs for psychological reasons (regardless of the change in the 'price' of giving) or trying to create a society in which individuals are engaged with the charitable sector.[130]

The stated objectives of Section 848A largely satisfy the above conditions in that it allows individuals decide to which charities revenue should be allocated, it allows the government to commit more resources to the sector and its design was based on the premise that people react positively to tax relief for psychological reasons and this in turn would encourage greater involvement with charities and encourage more donations. Section 847A is very much an extension of Section 848A. Encouraging donations to sporting bodies is seen as another way of encouraging a philanthropic spirit and supporting a cause from which society in general will benefit.

[130] Banks, James and Sarah Tanner (1998), Taxing Charitable Giving, Institute of Fiscal Studies, p. 20.

Appendix B.2: International Comparisons

International Comparisons for tax relief on donations to charities and approved bodies

United Kingdom

In the UK, the "Giving Campaign" was launched in July 2001 as a three-year national initiative to encourage and increase charitable giving, in the main through increasing awareness and the promotion of tax effective giving. It was hoped that in the long term this would give rise to a stronger culture of giving in the UK.

The UK has a very comprehensive system of reliefs to provide incentives to both individuals and businesses to give to charity. Briefly, there are three ways that individuals can give to charity tax efficiently -

- Gift Aid – donors can make payments, regular or one-off, to charities. There are no thresholds. The donor gives the charity a declaration confirming that they will pay an amount of income tax or capital gains tax equal to the tax the charity claims on their donation. The charity can claim the basic rate (22%) from Revenue and Customs. Donors who are liable to the higher rate of income tax can claim the difference between the higher rate and the basic rate. From April 2004, self assessment returns have allowed a taxpayer to nominate a charity to receive a tax repayment due to him/her as a result of making a tax return.[131] Gift Aid brings in 27 times as much as payroll giving.[132]
- Payroll Giving – this provides tax relief at source for individuals who give to charity by direct deduction from their pay. The donor gets tax relief immediately at their marginal rate and there are no upper or lower limits on the amount donated. The donor authorises their employer to make a deduction from their pay which they hand over to a Payroll Giving Agency approved by the Inland Revenue. This agency then distributes the money to the charity of the donor's choice. The agencies are charities in their own right and a small fee may be deducted from the gift to cover the agency's administration costs – usually no more than 4 per cent or 35p per donation, whichever is greater. However, some employers pay the agency's charges so that the full amount of the employee's donation goes to their chosen charity.
- Giving land, buildings, shares or securities – individuals can claim a deduction for the gift against their income for income tax purposes.[133]

Business can give tax efficiently through -

- Gift Aid – companies can make a payment to charity and then deduct that amount in computing its profits for corporation tax purposes for the accounting period in which the donation was made.
- Employers can also get tax relief for the costs of administering the payroll giving scheme as an allowable expense on their business. If they choose to sponsor the payroll giving agency's costs they can also get tax relief for these costs. In addition, employers who choose to match their employees' donations

[131] UK Revenue and Customs, *Charitable Giving Through the SA Tax Return,* www.hmrc.gov.uk
[132] Pharoah, C., C. Walker, L. Goodey and S. Clegg (2004), *Charity Trends 2004,* Charities Aid Foundation, p. 152.
[133] UK Revenue and Customs, *IR65 – Giving to charity by individuals,* www.hmrc.gov.uk

to charity can get tax relief for such matching donations either as an allowable expense of their business or under the Gift Aid scheme.[134]

- Giving land, buildings, shares or securities – companies can claim a deduction for the gift for corporation tax purposes.
- Giving business assets – relief is available to businesses that gift an article to charity that is either an item manufactured or sold in the course of the trade or machinery or plant used in the course of the trade.[135]

Despite all these reliefs, a recent report commissioned by Revenue and Customs in the UK to increase understanding of the relationship between charitable giving among individual citizens and the tax relief available on their gifts noted that the total value and frequency of charitable donations made by individual citizens in Britain has remained unchanged since 1988. The report noted that there seems to be no direct relationship between the rules of tax relief and the amounts people give. In the reasons people gave for giving and not giving, or claiming and not claiming, few said that a calculation of the added value of tax relief determined how much they gave to charity.[136]

In the UK, studies have indicated that ninety per cent of people gave to charity in the last year. Of those who gave to charity in ways that attract tax relief, less than half (43 per cent) said they believed that they had used the tax relief attached to their giving. Those that had not used tax relief on qualifying gifts rarely showed any resistance to the principle of doing so. They said that they had not got round to it, that they gave only occasionally, that they gave small amounts and thought tax relief applied only to significant or regular donations, or they were simply unaware such opportunities existed. Only six per cent thought the government should stay out of such matters. Qualitative respondents sometimes complained they were not sufficiently prompted by receiving charities.[137]

In the UK, charities are failing to take full advantage of the reliefs available to them. A 2004 report noted that charities were potentially missing out on revenues because they are failing to promote to donors the Share Giving scheme. The scheme launched in the 2000 budget, allows individuals to give shares and offset the value of the shares sold against their income tax liability and reduce their capital gains tax liability. However, research indicated that charities have been reluctant to promote the Share Giving scheme with 40% of charities not marketing Share Giving to all their supporters, and over 30% of charities not even marketing it to their high value supporters.[138]

The UK Revenue and Customs report noted that while there was no obvious relationship between the rules of tax relief and the amounts that donors give, the availability of tax relief undoubtedly encouraged the incidence of planned giving.

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[134] UK Inland Revenue and Customs, *Charities*, www.hmrc.gov.uk/stats/charities

[135] UK Revenue and Customs, *IR64 – Giving to charity by businesses*, www.hmrc.gov.uk

[136] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, p. 4.

[137] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, p. 5.

[138] Saxton, Joe and Alexandra Denye (2004) Share Giving – *Sheer Indifference: A Research Report on the use of Share Giving by Charities*, www.givingcampaign.org.uk, p. 2.

‘More than half the Payroll Givers and Gift Aid users said tax relief was important to them in their decision to give in this way. The majority of users said that the fact that the charity got more money as a result was the most important reason for using that method of donation, but, having chosen this method and put it into effect, they said they would continue to do it even if tax relief was no longer available.’[139] The report noted that one potential concern associated with this form of giving is that people may concentrate their donations into this method and as consequence other smaller charities lose out in this process of ‘rationalisation’.

According to the UK Treasury, when the £250 floor was abolished in the Gift Aid scheme, anecdotal evidence from charities suggested that the immediate impact was that a number of donors began to give smaller amounts, below the £250 level, perhaps splitting what they had previously given to one charity between two. However, the number of charities using Gift Aid has grown considerably and the amounts of tax claims has also risen as more charities use Gift Aid or charities convert more of their donors to using the scheme.[140]

Year	**Number of UK Charities using Gift Aid**	**Tax repaid to charities on donations (sterling)**
2000/01	25,306	£222m
2001/02	45,007	£415m
2002/03	50,846	£506m
2003/04	55,762	£586m
2004/05	60,329	£625m

Source: UK Treasury

In the UK a discrepancy has been noted between income level and the level of gift - those with more give less and those with less give more- the richest 20% give 0.7% of their household expenditure to charity while the equivalent figure for the poorest 10% is 3%.[141] With this in mind, the Giving Campaign explored the higher income segment of the population with a view to understanding how they decided on the level of charitable gift they gave and how an increase could be encouraged. They discovered that while tax relief may encourage people to give more, ultimately individuals had to feel that they had the money available to give in the first place. Other considerations were the desire to ‘do good’ and to ‘make a difference’ and the desire to support a charity or cause with which the donor feels affinity and is confident will make a difference.[142] Two key enhancements were identified that would encourage higher giving levels (i) givers support the further development of tax-effective measures to benefit charities – in addition to increasing the levels of tax advantage, existing schemes should be communicated more widely and their operation should be as convenient as possible; (ii) the charitable sector should address the concerns of givers in terms of providing greater financial accountability, communicating more tangibly the achievements in relation to their core mission,

[139] Smeaton, Deborah, Alan Marsh, Ruth Rajkumar and Andrew Thomas (2004), *Individuals' Donations to Charities and their Use of Tax Relief*, www.hmrc.gov.uk, p. 63.
[140] Data supplied by UK Treasury.
[141] NOP World Financial (2004), *How People Decide on the Level of the Gift*, www.givingcampaign.org.uk, p. 1.
[142] NOP World Financial (2004), *How People Decide on the Level of the Gift*, www.givingcampaign.org.uk, pp. 60-61.

charities with similar/identical aims should consolidate and tighter regulation should be enforced to eliminate fraud and inappropriate activities.[143]

The UK, unlike Ireland, has an established regulator of charities. The Charity Commission regulates charities, so as to promote compliance with charity law and to increase charities' effectiveness. They aim to enable charities to maximise their potential and enhance their accountability to donors and those who benefit from charities. The end result should be increased public trust and confidence in charities.[144] Such a body is planned in Ireland and is necessary for the further development of the sector and relevant tax reliefs.

United States

Generally, donors can deduct contributions of money or property made to, or for the use of, a qualified organisation. A gift or contribution is 'for the use of' a qualified organisation when it is held in a legally enforceable trust for the qualified organisation or in a similar legal arrangement. Qualified organisations include, but are not limited to, federal, state, and local governments and organisations organised and operated only for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals. The deduction that can be claimed is limited to 50% of the donor's adjusted gross income. This may be limited to 30% or 20% depending on the type of property given or the type of organisation to which the donation is made.[145]

Donors can generally deduct cash contributions as well as the fair market value of any property donated to qualified organisations. For a contribution of $250 or more, the donor must obtain a written acknowledgment from the qualified organisation. If donors make a contribution of non-cash property worth more than $5,000 generally an appraisal must be done. Although donors cannot deduct the value of their time or services, they can deduct the out-of-pocket expenses incurred while serving a qualified organisation as a volunteer.

Donors cannot deduct contributions made to specific individuals, political organisations and candidates, the value of their time or services and the cost of raffles, bingo, or other games of chance. Donors also cannot deduct contributions given to qualified organisations if, as a result, they receive or expect to receive a financial or economic benefit equal to the contribution. If a contribution entitles the donor to merchandise, goods, or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, the donor can deduct only the amount that exceeds the fair market value of the benefit received.[146]

In American literature, a negative relationship between levels of taxation and the level of charitable donations is generally found, suggesting that more generous tax relief will trigger higher level donations. Findings from American based research are not however necessarily applicable to charitable behaviour in the Ireland. In the United States, tax incentives benefit the donor whereas for the PAYE sector in Ireland the

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[143] NOP World Financial (2004), *How People Decide on the Level of the Gift*, www.givingcampaign.org.uk, p. 13.
[144] The Charity Commission And Regulation, www.charity-commission.gov.uk
[145] Internal Revenue Services, *Publication 526 – Charitable Contributions*, www.irs.gov
[146] Internal Revenue Services, *Topic 506 – Contributions*, www.irs.gov

relief benefits the charities or approved body. Also, the requirement to complete annual tax returns by American citizens results in them being more aware of the value of the deduction and this in turn leads to the common practice of annual deliberative giving. By contrast, in Ireland many donations continue to be of the spontaneous variety and PAYE taxpayers are not required to make an annual return.

Studies from the United Kingdom have looked at the differences between levels of giving in the US and the UK. When UK fundraisers were asked for their views on this issue they were aware of the higher levels of giving in the US. '**B**ut quite where this success lies was unclear. Tax breaks were felt to play a significant role and some wondered how much of this was attributable to church going (thought to be high in the US) given that levels of giving are often higher among these communities. Credit was also given to the culture as a whole, feeling that the US were just more inclined to give money away, perhaps due to the fact that they were used to paying for a range of services that in the UK the State has traditionally provided.'[147]

New Zealand

An individual can apply for a tax rebate if he/she has donated $5 or more to a charitable organisation and has earned a taxable income during the period being claimed for. The maximum rebate that can be claimed is $630 for donations of $1,890 or more, if a claim is made for less than the maximum the donor receives a third of the total amount as a rebate.[148]

If a company makes a donation to a charity approved by the Inland Revenue it can claim a tax deduction. The maximum deduction it can claim is 5% of the company's net income calculated before taking into account the deduction.[149]

Australia

Deductions for gifts are claimed by the person or organisation that makes the gift. A donor can be an individual, company, trust or other type of taxpayer. To be tax deductible, a gift must be made to a Deductible Gift Recipient (DGR). A DGR is an organisation that can receive income tax deductible gifts. It is endorsed by the tax office or listed by name in the tax law. Also the gift must not give rise to any benefit or advantage to the donor, it must be of money or a certain type of property and comply with relevant gift conditions.

The amount of the deduction depends on the type of gift. For gifts of money, it is the amount of the gift. For gifts of property, there are various valuation rules. A deduction for a gift cannot add to or create a tax loss for the donor. However, donors can elect to spread deductions for certain gifts over a period of up to five years.[150]

[147] NOP World Financial (2004), *How People Decide on the Level of the Gift*, www.givingcampaign.org.uk, p. 85.
[148] Inland Revenue, *Individual Income Tax - Donations, childcare and housekeeper rebates,* www.ird.govt.nz
[149] Inland Revenue, *Business Income Tax – Claiming rebates for donations to non-profit organisation*, www.ird.govt.nz
[150] Australian Tax Office (2005), *Gift Pack – for deductible gift recipients and donors*, www.ato.gov.au

Canada
Generally, donors can claim a federal and provincial or territorial tax credit when they donate to a registered Canadian charity, a registered amateur athletic association, certain housing corporations, Canadian municipalities, the United Nations, certain foreign charities or the Government of Canada, a province or a territory.

Where the gift is less than $200, the federal tax credit is calculated as 16% of the amount of the gift. Where donations exceed $200, the credit is 29% of the amount of the gift (provincial and territorial rates differ).[151]

An individual is entitled to claim part or all of the eligible amounts of their gift, up to the limit of 75% of net income for the year. This limit can be increased for gifts of capital property.[152]

International Comparisons for tax relief on donations to sports clubs

United Kingdom
Individuals who are UK taxpayers can make gifts to Community Amateur Sports Clubs (CASCs) using Gift Aid in the same way as they can make gifts to charities. Relief is available for gifts made to a registered CASC after 6 April 2002. Gift Aid is only available for gifts to CASCs and not for other payments such as membership subscriptions. A CASC can reclaim basic rate tax on donations made by individuals, whether large or small, regular or one-off, provided the conditions for the Gift Aid scheme are satisfied.

Gifts made using Gift Aid are treated as having been paid after deduction of basic rate income tax. As long as the CASC applies the income for qualifying purposes it can claim repayment of this tax from Inland Revenue Charities (28p for each £1 donated (while the Basic Rate is 22%))[153] If the donor pays tax at the higher rate they can claim additional relief in their self-assessment tax return.

Companies cannot make gifts to CASCs using Gift Aid, but can normally claim a deduction in computing their profits for either formal sponsorship of a sports club or for payments made to enhance their standing in the local community.[154]

United States
Donations to amateur athletic organisations are deductible as charitable contributions on the donor's federal income tax return once there is no direct personal benefit to the donor or any other person other than the organisation.[155]

Australia
Sports clubs are treated in a similar way to charities. A donor can be an individual, company, trust or other type of taxpayer. To be tax deductible, a gift must be made to

[151] Canada Revenue Agency (2005), *Tax Tip – Helping others could help you too!*, www.cra-arc.gc.ca
[152] Canada Revenue Agency (2004), *P113 – Gifts and Income Tax*, www.cra-arc.gc.ca
[153] Amount of Gift * (Marginal Rate of Income Tax)/(100- Marginal Rate of Income Tax)
[154] UK Revenue & Customs, *Community Amateur Sports Clubs: Guidance Notes*, www.hmrc.gov.uk
[155] Inland Revenue Services, *Publication 557 - Tax-Exempt Status for Your Organisation,* www.irs.gov

a sports club with 'Deductible Gift Recipient (DGR)' status. A DGR is an organisation that can receive income tax deductible gifts. It is endorsed by the tax office or listed by name in the tax law. Also the gift must not give rise to any benefit or advantage to the donor, it must be of money or a certain type of property and comply with relevant gift conditions.

The amount of the deduction depends on the type of gift. For gifts of money, it is the amount of the gift. For gifts of property, there are various valuation rules. A deduction for a gift cannot add to or create a tax loss for the donor. However, donors can elect to spread deductions for certain gifts over a period of up to five years.[156]

Canada

Generally donors can claim a federal and provincial or territorial tax credit when they donate to a registered amateur athletic association. Where the gift is less than $200, the federal tax credit is calculated as 16% of the amount of the gift. Where donations exceed $200, the credit is 29% of the amount of the gift (provincial and territorial rates differ).[157]

An individual is entitled to claim part or all of the eligible amounts of their gift, up to the limit of 75% of net income for the year. This limit can be increased for gifts of capital property.[158]

[156] Australian Tax Office (2005), *Gift Pack – for deductible gift recipients and donors*, www.ato.gov.au
[157] Canada Revenue Agency (2005), *Tax Tip – Helping others could help you too!*, www.cra-arc.gc.ca
[158] Canada Revenue Agency (2004), *P113 – Gifts and Income Tax*, www.cra-arc.gc.ca

Appendix 3: Copy of Letter and Survey sent by Department of Finance to a sample of 100 companies

July 2005

Dear 'Named Chief Financial Officer',

As you may be aware, in his Budget 2005 statement of 1 December 2004, the Minister for Finance, Mr. Brian Cowen, T.D., announced that the Department of Finance and the Revenue Commissioners would carry out an evaluation of the effect of certain tax incentive reliefs and exemptions.

As part of that review, a study is being undertaken of the tax relief for Donations to Eligible Charities and Other Approved Bodies including Sports Bodies. In measuring the impact of these schemes, it is important that we can measure the level of voluntary contributions made by companies. Due to the way companies claim this relief it is not possible to capture this figure by way of tax returns. Consequently, to obtain the information required, it is necessary to conduct a survey of selected companies. The Minister would consider it helpful if you agreed to participate in the survey and return the completed form by 29 July 2005 to the address given on the form.

If you have any queries on this issue please contact Emma Cunningham at 01 6318086 or Marianne Nolan at 01 6045594.

With best wishes,

Yours sincerely,

____

Donal McNally
Head of Budget & Economic Division

Review of Schemes for Tax Relief for Donations to Eligible Charities and Other Approved Bodies (Section 848A, Taxes Consolidation Act 1997) and Tax Relief for Relevant Donations to an Approved Sports Body for the Funding of Approved Projects (Section 847A, Taxes Consolidation Act 1997)

Please see attached guidance notes

1. Name of Company: ______________________________

2. Do you have an annual budget for donations? Yes ☐ No ☐

3. If so what was the size of this budget in last calendar or accounting year?

   €___________________

4. What percentage of your company's turnover does this represent?

   ___________________%

5. How much of your donations budget goes to charities and approved bodies and is tax deductible under the scheme of tax relief for donations to eligible charities and other approved bodies?

   €___________________

6. Has the amount your company donates to charities and approved bodies increased **as a result of** the introduction in 2001of the scheme of tax relief for donations to eligible charities and other approved bodies?

   Yes ☐ No ☐

7. Since the introduction of the tax relief scheme for donations to eligible charities and other approved bodies in 2001 how has the amount you donate to the following areas changed?

	Donate More	Donate Same	Donate Less
Schools			
Third Level Institutions			
Domestic Charities			
Third World Charities			
Other			

8. How much of your donations budget goes to approved sports bodies and is tax deductible under the scheme of tax relief for donations to an approved sports body for the funding of approved projects?

€ ____________________

9. Has the amount your company donates to approved sports bodies increased **as a result of** the introduction in 2002 of the scheme of tax relief for donations to an approved sports body for the funding of approved projects?

Yes ☐ No ☐

10. Do you think that the amount your company donates would be reduced if the tax reliefs were reduced or abolished

Yes ☐ No ☐

11. If yes, could you estimate by what percentage? ____________%

Guidance Notes

<u>Question 1</u>

Information received in the course of this survey will be regarded as confidential and used only in an aggregated form. Statistics or data released will not include any information that identifies individual companies who have participated in this survey.

Information received from your company in the course of this survey will enjoy protection in the normal course under Section 26 (1) (a) of the Freedom of Information (FOI) Act which states that a head shall refuse to grant a request if *'the record concerned contains information given to a public body in confidence and on the understanding that it would be treated by it as confidential …and, in the opinion of the head, its disclosure would be likely to prejudice the giving to the body of further similar information from the same person or other persons and it is of importance to the body that such further similar information as aforesaid should continue to be given to the body'*. Alternatively, Section 26 (1) (b) of the Act provides that a head shall refuse to grant a request if *'disclosure of the information concerned would constitute a breach of a duty of confidence provided for by a provision of an agreement or enactment…or otherwise by law'*.

If you consider the information contained in your response to be confidential and falling within the exemption provided in Section 26, it would be desirable to enter into an agreement with the Department regarding its protection under Section 26 (1) (b) of the FOI Act. In order to formalise such an agreement, please complete and sign the consent form below and return it with your response to the survey.

<u>Question 5</u>

Section 848A of the Taxes Consolidation Act, 1997 provides for a scheme of tax relief for certain charities and other approved bodies in respect of donations received on or after 6 April 2001. The minimum donation in any year that must be made to any one eligible charity or approved body is €250. Where there is no association between the donor and the charity(s)/approved body(ies) to which the donation is made, there is no maximum qualifying donation. Companies claim a deduction for the donation as if it were a trading expense. Further information about this scheme is available on www.revenue.ie.

<u>Question 8</u>

Section 847A of the Taxes Consolidation Act 1997 provides for a scheme of tax relief for relevant donations to an approved sports body for the funding of approved projects. The scheme is applicable only to relevant donations received on or after 1 May 2002 in respect of expenditure incurred on approved projects on or after that date. The minimum qualifying total donation amount by a single donor in any year to an individual sports body is €250. Companies claim a deduction for the donation as if it were a trading expense. Further information about this scheme is available on www.revenue.ie.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section C:

Tax Relief for Expenditure on Significant Buildings and Gardens – Section 482 of the Taxes Consolidation Act 1997

Contents

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1. Executive summary

1.1 Tax relief for expenditure on significant buildings was introduced in Section 19 of Finance Act 1982 (subsequently Section 482 of the Taxes Consolidation Act 1997). Relief from income tax and corporation tax is provided to the owner/occupier of an approved building in respect of certain expenditure for the repair, maintenance or restoration of the approved building. The relief is granted subject to public access to the building in question being allowed. Public access is the cornerstone of the relief.

1.2 Since its inception the relief has been amended to include significant gardens and to provide that buildings used as guesthouses do not have to meet the public access requirement. Tax relief on passive investment in an eligible property is allowed on sums up to €31,750 per annum.

1.3 The cost of the relief is relatively low. During the period 1997/1998 to 2002, the relief cost an average of €2.4 million per year with an average number of 45 claims per year processed. Almost 230 properties have availed of the relief since its inception. Currently 167 properties are eligible to claim the relief. Around 50% of the relief is claimed by people on the list of the top 400 high income individuals

1.4 Owners who use the scheme regard it favourably and many see it as an essential tool in allowing them to maintain their properties without being forced to sell. Both the Dooley Report, published in 2003, and the Indecon Report, published in 2004, acknowledge the importance of Section 482, but argue that resources could be better targeted at the most needy owners.

1.5 Many other countries operate tax schemes designed to assist in the maintenance of heritage properties. Australia operates a scheme most similar to the relief offered in Ireland.

1.6 While there are a number of options open to make changes to the relief, continuation of the scheme as it stands seems the most reasonable option, subject to ongoing review. If further assistance to owners of significant buildings and gardens is required, an increase in the level and scope of grants available would seem a more appropriate mechanism for providing this.

2. Background

2.1 Section 19 of Finance Act 1982 (subsequently Section 482 of the Taxes Consolidation Act, 1997) provided relief from income tax and corporation tax to the owner/occupier of an approved building in respect of certain expenditure for the repair, maintenance or restoration of the approved building. The relief was introduced by the then Minister for Finance, Mr. John Bruton, T.D., in his Budget of January 1982, and was included in the Finance Act 1982 by his successor, Mr. Ray MacSharry, T.D., following the change of Government resulting from the defeat of Minister Bruton's Budget in the Dáil.

2.2 The aim in introducing the scheme, as stated by Deputy Bruton during the Second Stage debate on the Finance Bill in 1982, was that "the tax concession for historic buildings…will encourage people to continue to live in them and not allow them become derelict."[159] Minister MacSharry concurred that "it does not matter about the size of a house so long as it is of suitable historical value and the public have access to it."[160]

2.3 The introduction of the relief was favoured by all sides of the Dáil. It was agreed that the relief would only be granted subject to allowing public access to the building in question on at least thirty days each year.

2.4 Providing tax relief means the use of public funds. These funds cannot be spent purely on securing the benefit of private owners. Public access is the price of obtaining this relief. This is the only way to justify the use of public money to restore and maintain private amenities.

Changes to the relief

2.5 In 1993, the scheme of tax relief for expenditure on significant buildings was extended to include gardens in their own right. In 1994, the number of days on which public access should be allowed was increased to sixty, of which forty days had to be between 1 May and 30 September. In 1995, the scheme was amended to provide that buildings in use as guest houses did not, subject to certain conditions, have to meet the public access requirement.

2.6 The 1997 Finance Act extended the scope of Section 482 to cover expenditure on alarms, insurance and the restoration of contents up to a maximum expenditure of €6,350 (£5,000) per annum provided the contents in respect of which qualifying expenditure has been incurred are to be kept on display for a minimum of two years.

2.7 Finance Act 2000 amended the scheme so that ten of the forty days from 1 May to 30 September on which public access is allowed must be either Saturdays or Sundays.

2.8 Finance Act 2002 introduced a number of technical changes to Section 482 including provision to make clear that expenditure incurred before 1997/1998 in

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159 Finance Bill Second Stage debate, 9 June 1982
160 Finance Bill Committee Stage debate, 7 July 1982

relation to an approved garden must, in order to qualify for relief, have been incurred by the person who owned or occupied the garden.

2.9 Finance Act 2002 also introduced a measure whereby when a claim for relief is made in respect of qualifying expenditure incurred on an approved building, the amount of relief allowable to an individual who acquires ownership of the building through participating in a passive investment scheme is restricted to €31,750 per annum.

2.10 Finance Act 2005 introduced a measure whereby the owner or occupants of approved buildings or gardens must advertise the dates and opening hours applicable to the satisfaction of the Revenue Commissioners. In addition, authorised officers of the Revenue Commissioners were given the power to make unannounced visits to ensure that the requirement of reasonable access is being met.

Operation of Section 482

2.11 Expenditure is treated for tax purposes as if it were a loss and the normal rules for giving loss relief apply. Unrelieved qualifying expenditure incurred in a particular year can be carried forward for a two year period. For example, if a taxpayer incurs €350,000 on a significant building in the tax year 2003 and has taxable income as follows:

	Taxable income	**Tax relief**	**Net taxable income**
2003	€125,000	€125,000	Nil
2004	€150,000	€150,000	Nil
2005	€175,000	€75,000	€100,000

2.12 Relief in respect of qualifying expenditure incurred in a chargeable period will be limited to the amount of the expenditure attributable to the actual work carried out during that chargeable period.

2.13 For a building or garden to be approved it must satisfy the following requirements:

(a) The building must have been determined by the Minister for the Environment, Heritage and Local Government (formerly the responsibility of the Minister for Arts, Heritage, Gaeltacht and the Islands) to be a building which is intrinsically of significant scientific, historical, architectural or aesthetic interest. In relation to a garden, it must be a garden which is intrinsically of significant horticultural, scientific, historical, architectural or aesthetic interest.

(b) The Revenue Commissioners must determine that reasonable access is provided to the building or garden for members of the public or in the case of a guest house that it is in use as a guest house for at least six months of the year. Under this scheme, approved buildings and gardens must be open to the public for five chargeable periods from when the relief is granted to the owner/occupier. Specifically,

- Access to the whole or a substantial part of the building/garden must be available at the same time.

- Access must be allowed annually for not less than sixty days in any one year, including not less than forty days during the period from 1 May to 30 September. Ten of those forty days must fall on Saturdays or Sundays.

- The daily viewing times must be at least four hours in duration.

- If there is an admission price it must be reasonable.

- Opening times must be advertised in local or national papers.

- A sign must be erected outside the building indicating opening times.

- Information regarding access must be supplied to Fáilte Ireland on the understanding that this information may be published in tourist information guides.

2.14 There is provision for either the Revenue Commissioners or the Minister for the Environment, Heritage and Local Government to revoke the relief when the conditions under which the relief was granted cease to apply. Any relief granted to a claimant in the five year period immediately before the determination is revoked will be clawed back.

2.15 While in order to avail of Section 482 a building must be approved, it does not need to be listed on the Record of Protected Structures.

3. The cost of the relief to the Exchequer

3.1 The cost to the Exchequer of tax relief for significant buildings and gardens is relatively low. Figures supplied by the Revenue Commissioners for the years 1997/1998 through to 2002 show the following:

	Claims allowed	**Cost €m**
1997/1998	36	1.9
1998/1999	50	1.9
1999/2000	56	3.9
2000/2001	44	2.7
2001 (short tax year)	28	0.4
2002	54	3.7
Average	**45**	**2.4**

3.2 Figures from 2000/2001 and 2002 show that a large portion of the relief was claimed by those on the list of the top four hundred high income individuals with an effective income tax rate of 30% or less.

3.3 In 2000/2001, four of the 115 individuals with an effective rate of 30% or less claimed tax relief under Section 482, while in 2002 three of the 194 individuals with an effective rate of 30% or less did so. The total relief claimed by the four claimants in 2000/2001 was €1.63 million, at an average of €408,000, while the equivalent figure for the three claimants in 2002 was €1.1 million, at an average of €368,000. The total income of the above claimants in 2000/2001 ranged from €740,000 to €3 million, while in 2002 it ranged from €678,000 to €1.9 million.

3.4 While there is no doubt that high income individuals are claiming a large share of the relief, it should be noted that buildings of significant scientific, historical, architectural or aesthetic interest are of their nature more likely to be owned by wealthy individuals. None of the three claimants from 2002 was amongst the four referred to from 2000/2001, which suggests that large claims tend to be made on a once-off rather than on a continuous basis.

4. Numbers availing of the relief

4.1 Almost 230 properties have availed of Section 482 since its commencement. The figures for 2005 show that there are currently 167 properties eligible to avail of the relief. A revised list of the qualifying properties is published annually by Fáilte Ireland in conjunction with the Revenue Commissioners. Approximately 40% of the owners of heritage properties in Ireland have availed of the relief at some point.

4.2 The properties are spread over a wide range geographically, with 23 of the 26 counties represented. Dublin accounts for around 16% of the properties, while Cork accounts for around 11%.

4.3 Eighteen of the properties are guesthouses. Of the remaining 149 properties, 38 allow admittance for free. The average price of admittance to the rest of the properties is €5.88. However, the majority allow discounts for pensioners and children, while many also operate a discount for groups. Guided tours are available in several of the properties.

5. Views of various interested parties on the scheme and assessment of benefits

Owners

5.1 The relief for significant buildings and gardens is regarded very favourably by owners. Several argue that they would not be in a position to maintain their properties without the existence of the relief. However, many would like the relief to be extended.

5.2 "The Hidden Ireland" is a group representing private owners of heritage properties of various sizes who provide public access. They made a submission to the Minister for the Environment, Heritage and Local Government in June 2005 concerning possible proposals for a National Trust. However, they devoted a significant part of the submission to Section 482. While they describe the relief as "a vital piece of legislation", they also say that "many of those who wish to use it do not have sufficient income to use the scheme to fund major conservation repairs." They believe that Section 482 has become more attractive for wealthy people purchasing derelict old houses than for those whose "authentic" houses need repairs. According to The Hidden Ireland, this can lead to owners being forced to sell either their entire property, some of the contents of their houses, or adjoining land.

5.3 Among the suggestions in their submission, The Hidden Ireland propose that the amount of relief allowable to an individual who acquires ownership of the building through participating in a passive investment scheme should be increased to €50,000 per annum. They further suggest a VAT exemption for maintenance and restoration work on significant buildings, as well as a CGT remission when an owner sells assets to fund restoration.

Dooley Report

5.4 In his report, “A Future for Irish Historic Houses”, sponsored by the Irish Georgian Society and the Department of the Environment, Heritage and Local Government and published in September 2003, Dr. Terence Dooley reiterates the point made by The Hidden Ireland when he says that “While those who avail of Section 482 status generally agree that it represents an enlightened approach, they justly argue that it requires some modification because it is of relatively little value to any owner who does not have a high taxable income.”[161] Dr. Dooley sees a number of drawbacks to the rules governing the relief, arguing that it is too inflexible and that many people who could usefully avail of the relief are precluded from doing so:

- It is impractical for certain properties, such as those located on islands, to be open to the public on more than a few days per year.

- Owners of some properties feel that their houses would be too small to sustain large numbers of visitors.

- Some owners of houses with valuable contents worry that allowing large numbers of people into their property represents a security threat.

- Elderly owners who have opened their houses for a specified number of years should be allowed a period of grace before their houses are taken over by new owners or another member of the family.

- Some owners are not aware that the option of availing of Section 482 is open to them.

- Discretionary trusts cannot avail of the relief.

5.5 Dr. Dooley also argues that the sales of contents of significant buildings should not be subject to Capital Gains Tax and that a lower tier of VAT should apply to repairs carried out on qualifying buildings. He further contends that original owners of significant buildings should be treated differently for tax purposes than wealthy new owners;

> “…there needs to be a distinction with regard to the exemptions and concessions allowable to original owners who may be financially struggling to preserve their houses and new purchasers who have the private wealth to restore houses themselves. It should be recognised that fiscal arrangements should be geared more towards those original families who most need them in order to maintain their homes.”[162]

[161] Dooley, 2003, p.31
[162] Dooley, 2003, p.41

5.6 However, Dr. Dooley concludes by saying that

> "At the end of the day, it is not taxation that is the main problem for most of the original owners; rather it is the lack of income/funding. More grant aid is essential rather than more tax exemptions."[163]

Indecon Report

5.7 In November 2004 Indecon Consultants completed a report commissioned by the Department of the Environment, Heritage and Local Government, "Examination of the Issue of Trust-type Organisations to Manage Heritage Properties in Ireland". Indecon say that while a large number of properties are in receipt of the relief and it has supported the maintenance of Irish heritage, "it is unlikely that all of these properties…need this support or are of significant heritage value and/or attract a large number of visitors."[164] They go on to say that "A more selective approach to properties that could avail of this relief might save resources that could be targeted elsewhere to support properties under threat."[165]

5.8 Indecon also state that some owners of significant buildings would have been in a financial position to carry out restoration work or repairs even without availing of the tax relief.

Department of the Environment, Heritage and Local Government

5.9 The Department of the Environment, Heritage and Local Government sees Section 482 as a pivotal element in the protection of heritage properties in private ownership in Ireland. They argue that any measures reducing the scope of the relief would have negative connotations for heritage protection in general and that it would make necessary extra direct provision by the State. The relief can often mean the difference between repairs taking place and a building being left to deteriorate.

5.10 In addition, the rules concerning public access have a beneficial effect on tourism in Ireland, both domestic and international, especially as most of the viewing days occur during the main tourist season. This in turn often has a positive effect on employment in the locality in which the buildings are situated.

5.11 The Department also argues that Section 482 complements the various grants provided by the State towards the protection of architectural heritage properties in Ireland, most of which are in private ownership. Funding of €10.6m was provided for such grants in 2005. These include the Conservation Grant Scheme for Protected Structures, Urban and Village Renewal, the Thatching grant, a range of heritage grants administered by the Heritage Council and one-off grants to individual properties.

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[163] Dooley, 2003, p.33
[164] Indecon, 2004, p. 162
[165] Indecon, 2004, p. 162

Benefits of the relief

5.12 While the cost of the scheme is relatively low, it plays an important role in allowing owners of significant buildings both to maintain them and to remain as residents. It is difficult to place a "value" on heritage, but the relief undoubtedly benefits the Irish public and tourism in Ireland by providing access to historic buildings and gardens, most of which would otherwise remain closed to them. Many of the properties play a small role in providing local employment, both for people working in the properties themselves and for craft workers and trades people involved in the maintenance and restoration of the buildings.

6. International Comparisons

United Kingdom

6.1 The UK does not operate a scheme equivalent to Section 482. However, most heritage bodies have charitable status and are not subject to income or corporation tax or to VAT on their charitable activities. In addition, the British Government donates 28p for every £1 donated to those bodies with charitable status, provided the donor has paid income or capital gains tax equal to the tax deducted from their donations. Income and corporation tax can also be claimed back at the donor's marginal rate on the giving of shares.

6.2 The National Trust is the most important means through which heritage properties are preserved. If a house is presented to the Trust along with an endowment, the donor may continue to live in the house subject to public access and the retention of the "character" of the property. The house cannot be sold or mortgaged against the Trust's wishes. The property must be of national significance

6.3 There are a number of other heritage bodies throughout the UK, such as the Landmark Trust, which purchases old buildings, restores them and then lets them out to fund their upkeep.

United States

6.4 In the US the National Trust for Historic Preservation acquires and administers historic sites and also provides financial assistance to local preservation projects. It no longer receives federal funding but is instead funded by private and business donations. A small proportion of the membership fee is tax deductible.

6.5 The Federal Historic Preservation Tax Incentives Programme is jointly operated by the National Park Service, the Internal Revenue Service and the State Historic Preservation Offices. The programme encourages private sector rehabilitation of historic buildings by offering a 20% tax credit on the costs of repair or restoration. However, the tax credit is only available to properties restored for income-producing purposes (they must be used as such for at least five years following restoration) and is not available for restoration of a personal residence. If a portion of a personal residence is used for business purposes, then the tax credit can be claimed on the costs incurred on restoring that part of the building.

6.6 A number of states operate their own programmes. For example, Louisiana runs a Restoration Tax Abatement. If an owner improves or renovates a building which is listed in the National Register of Historic Places, the assessed value and the property assessment can be frozen at pre-improvement levels for five years, resulting in substantial tax savings. The tax relief is granted by the local taxing authority. This scheme can be used in conjunction with the Federal Historic Preservation Tax Incentive Programme, leading to further savings. While there is no set amount of money an owner must spend to qualify, for owner-occupied dwellings projects must be valued at at least 25% of the assessed valuation of the building.

Australia

6.7 Australia operates a similar programme to Section 482, whereby private owners of heritage buildings receive a 20% tax rebate on repair or renovation work carried out on their property. However, tax relief is not allowed for donations to historic heritage.

New Zealand

6.8 The New Zealand Historic Places Trust uses heritage covenants. The owner of a property and the Trust sign an agreement which is permanently attached to a property's title. Therefore all subsequent owners are bound by the covenant. Many of the covenants apply to residential properties, meaning that owners can ensure that any restoration work they carry out will be protected should they ever sell the property.

Canada

6.9 In Canada most heritage bodies are exempt from all income and business taxes, although in some provinces they may be subject to certain local taxes.

6.10 Some provinces operate their own schemes. For example, in May 2005 New Brunswick introduced a Heritage Tax Abatement Programme, whereby the owner of a designated heritage property is "forgiven" a portion of the provincial and municipal property taxes associated with the value of approved restorations for a four year period. The owner pays property tax on the pre-restoration value of the property in the first year following the restoration. They are subsequently excused 75% of the increase in the second year, 50% in the third year and 25% in the fourth year.

Belgium

6.11 In Belgium heritage societies are not subject to business taxes or VAT unless they operate as cooperatives or limited companies. Businesses and individuals subject to Belgium's higher tax rate can avail of tax relief of up to 5% of net profit when they donate to heritage groups. This applies only to cash donations; there is no deduction, for example, on the donation of shares.

France

6.12 In France not-for-profit associations such as heritage societies, whose activities are regarded as being for the benefit of the public, are exempt from all corporate and income taxes. Many such associations are also exempt from VAT.

7. Options for change

Abolish the relief

7.1 No case has been made for the abolition of the relief. While from some owners' point of view the scheme may not go far enough, the evidence of discussions with owners suggests that the relief is doing what it was intended to do in terms of assisting in the cost of repairs and restoration of significant buildings. Indeed, some owners would not have been able to maintain their properties without it.

7.2 The argument as to whether or not Section 482 provides value for money is a difficult one to quantify. It is not possible to put a "value" on culture or heritage. On balance, the relief assists in the maintenance of historic buildings and gardens and has led to public access being possible in places where it otherwise would not or which may even have become derelict.

Introduce measures to reduce the ability of high income individuals to avail of the relief

7.3 While Indecon suggested that Section 482 could be better targeted, they did not make a strong case for this. The most telling argument against the scheme is that of deadweight cost, i.e. that high income individuals who are availing of the relief would be able to afford to restore their properties without the existence of the scheme. However, clearly the existence of the relief provides a motivation for high income individuals to purchase certain properties. The question following on from this is what would happen to such properties if they were not purchased by wealthy people? It is likely that this would put more pressure on the recently announced Irish Heritage Trust, which will have finite resources and will not be in a position to make multiple purchases per annum. It is possible that introducing any such measure would lead to some significant buildings being left to go derelict or that it would ultimately lead to pressure on the State to subsidise them or cover the cost of refurbishment.

7.4 There is also the question of how such a measure would be implemented. For example, would a cap be placed on the amount of income against which the relief could be claimed? This would be extremely problematical unless a similar cap were introduced on other tax reliefs.

Increase the passive investment limit above the normal €31,750

7.5 Again, this is a measure which would be very difficult to justify without an equivalent change being introduced for other reliefs. As well as this, there is no limit on the number of people who can invest in one property; the limit of €31,750 does not preclude raising large sums of money towards a restoration or repair project.

Increase the relief for expenditure on alarms, insurance and restoration of contents above the normal €6,350

7.6 There may be a case for increasing this part of the relief, as insurance costs for owners of significant buildings tend to be very high and the figure has not been increased since its introduction in 1997. If there are calls to increase this limit, this would merit consideration. This part of the relief is exclusive to Section 482 and any increase should not lead to calls for increases in other reliefs.

Extend the relief to properties that do not cater for public access

7.7 The issue of the lack of availability of Section 482 for those owners of heritage properties who are not in a position to allow public access was raised in the Dooley Report.

7.8 This is not an option that can be recommended. Firstly, public access to significant buildings availing of Section 482 is a central tenet of the relief. Secondly, the introduction of such a change would most probably lead to a large increase in the number of claims submitted and therefore substantially increase the cost of the relief to the Exchequer. Thirdly, such a measure would undoubtedly encourage owners who provide access to the public not to continue doing so, which would represent a blow both culturally and to the tourist industry in Ireland.

8. Conclusion

8.1 While the calls from owners of significant buildings for the terms of Section 482 to be made more generous are understandable, it should be remembered that tax relief on repair, maintenance and restoration costs for significant buildings and gardens was not introduced as a panacea for owners of such properties. The relief was introduced to assist owners in meeting their costs, remaining in their homes and not allowing them to become derelict. If more assistance to owners of significant buildings and gardens is required, an increase in the level of grants available would seem a more appropriate mechanism for providing this.

8.2 Continuation of the scheme as it stands, subject to ongoing review, seems the most reasonable option. The purpose of the scheme fits in well with the various grants available to such properties, as well as the recently established Irish Heritage Trust. The cost of the scheme is low. To abolish or reduce the scope of the relief would go against the Government’s policy of safeguarding Ireland’s heritage. However, given the deadweight issue which arises, it would be appropriate that any horizontal measure introduced should apply to Section 482.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section D:

Tax Relief for Interest on Personal Loans taken out to acquire a Share in a Business or Partnership – Sections 248 and 253 of the Taxes Consolidation Act 1997

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1. EXECUTIVE SUMMARY

Summary

1.1. Section 248 of the Taxes Consolidation Act 1997 (TCA) provides unrestricted relief for individuals in respect of interest on moneys borrowed to purchase directly or indirectly (such as through a holding company) an interest in or make a loan to a trading company or a company whose income arises wholly or mainly in the form of rents or other income from property. Effectively this means a person making a loan to the company. The main condition to be satisfied before the relief can be given is that, taken as a whole, the period from the application of the loan until the interest was paid, the individual must have worked for the greater part of his/her time in the management or conduct of the business of the company or of a connected company.

1.2. In the same vein, section 253 of the TCA provides for unrestricted relief to be given to an individual for interest on money borrowed to enable him/her to acquire a share in a partnership or to contribute or advance money to a partnership. To ensure that the relief is confined to genuine cases, the condition is imposed that the individual must, throughout the period from the application of the proceeds of the loan until the interest is paid, have personally acted as a partner in the conduct of the trade or profession carried on by the partnership.

1.3. This is not a major relief in terms of the tax estimated to be forgone. It is a relief that was very much "of its time" in that it was an exception to the general bar on allowing tax relief on interest charged on borrowing for capital purposes. The section gives Exchequer support to individuals who take out loans to fund not only straightforward business investment *but speculation on property capital appreciation*. However, in so doing, it is arguable that it no longer is primarily meeting its original objectives, which were to provide employment and foster growth. This was to be achieved by encouraging involved individuals to invest in their own enterprises. If the provision did not exist, it would be difficult to build a persuasive case for the introduction of this relief today.

History

1.4. Personal loan interest charges could be used to reduce one's taxable income until 1974. In that year this general provision was capped to counter individuals with high income levels who were off-setting most of their income with claims for loan interest relief. The provision had no effect on interest on business borrowings. The cap was not intended to apply to personal borrowings used for genuine business purposes. Accordingly, relief is given against all income earned by individuals in respect of personal borrowings to acquire a material interest in a company and who are working on a full-time basis in the company.

1.5. In 1978 the unrestricted relief for personal borrowings was restored to employees and directors of private companies without a material interest, whether they are full-time or part-time. In the case of public companies the relief was capped at €3,050 per annum. In 1992 the relief was abolished for those acquiring shares in quoted companies. Certain anti-avoidance measures were enacted in 1998, 2003 and 2004.

Cost of the reliefs in terms of the tax forgone

1.6. The cost of the reliefs in tax forgone is estimated by the Revenue Commissioners to be €17 million in 2003. There were some 5,200 claimants for that year so the average cost per claimant is some €3,300. However, Revenue statistics for that year show that 66% of the relief is claimed by the top 22% of the claimants, all of whom declared income in excess of €200,000. For claimants in this cohort, the average tax cost is estimated at €11,700 and the average annual relieved interest charge is €28,300.

Benefits of the Relief

1.7. It has undoubtedly provided the opportunity for the principals of private limited companies to greatly reduce the cost of borrowing to provide risk capital. While there has been strong growth in the number of private companies being formed over the past thirty years it is not possible to link this in any way to this relief.

1.8. The principal aim of this tax incentive is to encourage investment in private companies by those involved in the company. It does this by reducing the cost of borrowing for this purpose to these individuals. When it was introduced, the marginal rate of tax was 77%, interest rates were around 14% and unemployment levels and inflation rates were high. The position has reversed and ameliorated with respect to all of these factors in the intervening period as shown below.

	1974	1989	2004
Marginal Tax Rate	77%	56%	42%
Interest Rate (Prime)	11.75%	11.00%	2.79%
Inflation Rate	17.0%	4.0%	2.2%
Unemployment Rate	n/a	15.0%	4.4%

(Source: Department of Finance; Central Bank of Ireland)

1.9. It would appear that use of the relief has become widespread amongst professionals (accountants, legal practitioners, architects) as well as property developers and property speculators. It can be manipulated to minimize the personal income tax liabilities of the principals and partners of property rental companies and connected holding companies. This was not the intention of the legislators whose stated wish was to see increased employment as a result of growth in businesses run by their owners and by employees with an investment stake. In any event, with the economy currently experiencing near ‘full’ employment and having to look outside the island for workers, there is little or no case for the relief to be retained because of any putative effect it may have on employment numbers. The policy on State support for employment purposes has developed and become far more refined since 1974.

Conclusions

1.10. The relief is primarily used by individuals involved in the professional field such as accountants, medical practitioners, architects, legal practitioners and by property developers or speculators.

1.11. There is no evidence linking the relief to increased employment or to it having any notable effect on economic growth. The restriction of the relief in 1992 so that it could not be used to acquire shares in publicly quoted companies had no discernable effect on the growth in their numbers since then.

1.12. The value of the relief is disproportionately distributed with the majority going to those earning over €200,000.

1.13. The estimated tax cost of the relief is increasing despite reductions in taxation rates and in rates of interest.

1.14. The companies which are benefiting from the relief are, in general, not those operating in the fields chosen to be actively supported by the State through Enterprise Ireland.

1.15. The scheme is out of line with international practice; only the UK has a similar provision and it is limited to close companies which are not involved in property investment.

1.16. While the relief has been the subject of recent anti-avoidance legislation, like all reliefs it can be the subject of tax planning attempts and there are some indications that tax planners are now turning attention to it to assist in the funding of overseas property acquisitions.

Recommendations

1.17. This relief should be curtailed and could be abolished. If it were abolished the saving would be of the order of €17 million. The options for curtailment and estimated savings are:

- Place a maximum on the amount of interest relief under section 248 and 253. Data available from the Revenue Commissioners suggests that if interest relief under S248/253 was restricted to the standard €31,750 the saving to the Exchequer would be of the order of €4 million.

- Allow relief only at the standard rate of income tax which would give a saving of some €9 million.

- Abolish the relief for investment in non-trading and rental companies, the estimated saving here would of the order of €5 million.

2. INTRODUCTION AND BACKGROUND

2.1. The Minister for Finance, Brian Cowen, T.D., announced in his Budget Statement on 1 December 2004 that the Department of Finance and the Office of the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and exemptions during the course of this year.

2.2. On 9 April 2005 the Minister for Finance announced the award of two external consultancy contracts for the reviews. One consultancy firm is examining the area-based renewal schemes and the other is examining various sectoral property tax incentive schemes.

2.3. As he made clear at the time of the budget, the review also involved the examination by the Department of Finance and the Revenue Commissioners of certain other tax reliefs and exemptions and the reliefs for interest on loans to invest in companies or partnerships was included in this context. The review was to be completed in time to inform the development of the 2006 Budget and Finance Bill.

2.4. The idea of a tax incentive is to encourage people to invest financial resources in a tax efficient manner for certain socio-economic objectives and, in so doing, to assist a class, sector or group because of this encouraged behaviour. The person pays less, or even no, tax as a result of their decision.

2.5. The behaviour being encouraged would be expected to meet all or most of the following criteria:

- Likely to encourage long term sustainable development and growth, in both absolute and value terms, in the target sector;
- Unlikely to attract money away from other classes of equal or higher worth and thus disadvantageously distort the market or class;
- Be reasonable and proportionate from the point of view of a cost-benefit analysis;
- Be a proper and appropriate use of the taxation system, i.e. not more suited to a grant type system or other straightforward voted expenditure;
- Unlikely to be abused due to the selective nature of the relief.

2.6. The second Report of the Commission on Taxation on Income Tax Incentives was published in March 1984. It stated that:

> *… it is not sufficient to show that the activity at which the incentive is directed is worthy and would benefit. If this criterion were accepted to justify incentives, virtually all items would qualify for incentives … because there is almost no activity which cannot be shown to benefit from a selective reduction in taxation.*[166]

[166] Commission on Taxation Second Report – Direct Taxation the Role of Incentives, p.18.

2.7. This observation remains true today: tax incentives are more embedded than grants because they are not subject to particular and regular spending scrutiny, they are harder to cost and arguably create greater distortions than direct spending. It is widely accepted that tax incentives should be used sparingly, for example to counter shortcomings in the market or wider economy.

2.8. It is also the case that a rational marketplace will mean that investment will take place where the investor believes that the expected return will be greater than the risk of losing his/her investment. If the risk of such loss is reduced or eliminated then the investment becomes more attractive and thus more likely to occur. A tax incentive does not directly address the underlying risk of the investment but reduces the extent of the return needed to make the investment viable.

2.9. It should also be said that there is evidence that employment cannot effectively or efficiently be incentivised or created by providing tax breaks for capital formation. If the goal is economic growth as measured by employment, tax incentives should subsidise the cost of labour, not the cost of capital. Economic theory and empirical evidence cast doubt on the effectiveness of capital subsidies in increasing employment.

2.10. There is, however, an argument that is founded on the existence of an understandable urge amongst those in the taxation 'net' towards reducing their tax liabilities. Tax is viewed by many business people as simply a cost to be managed. A recent newspaper article put it as follows:

> *… the competitive advantage of Ireland Inc lies … in its ability to … deliver on the tax needs of its customers as well. The reality is that for corporations, big or small, tax is a cost, not a social responsibility, not a moral issue and not a public good. Not only is tax a cost but the market judges the performance of companies on an after-tax basis.* [167]

2.11. Given the prevalence of this view, successive Irish Governments have decided to attempt to harness it and use it to encourage the direction of investment towards chosen economic, social and cultural areas.

[167] 'Ireland Inc losing out to competitors'; Irish Times, 15 July 2005.

3. THE NATURE AND OBJECTIVES OF THE RELIEF

3.1. The table below sets out the relevant sections of the Taxes Consolidation Act 1997, when they were each introduced and describes the provisions in brief. A more lengthy textual description is provided in the appendix. What will be referred to as 'the relief' in this report is actually set out in and governed by several different sections of the Act. Put simply the relief allows someone borrowing in order to lend money to or to acquire a share in a qualifying company or partnership to reduce their taxable income by the amount of interest payable on the loan.

TCA section (When introduced)	Title	Description
Section 248 (1974)	Relief to individuals on loans applied in acquiring interest in companies	The original provision which allowed genuine business related personal borrowings put into a company to be exempt from the general denial of interest deductibility.
Section 253 (1974)	Relief to individuals on loans applied in acquiring interest in partnerships	Original provision exempting personal borrowing to invest in a partnership to be exempt from the general denial of interest deductibility.
Section 250 (1978)	Extension of relief under section 248 to certain individuals in relation to loans applied in acquiring interest in certain companies	Relaxation of original provision to allow part time directors and employees avail of the relief.
Section 251 (1990)	Restriction of relief to individuals on loans applied in acquiring shares in companies where a claim for 'BES relief' or 'film relief' is made in respect of the amount subscribed for shares	Provides that relief not be given where BES or Film Relief is being claimed in respect of the same investment.
Section 252 (1992)	Restriction of relief to individuals on loans applied in acquiring interest in companies which become quoted companies	Removal of relief for individuals purchasing shares in quoted companies.
Section 248A (1998)	Restriction of relief in respect of loans applied in acquiring interest in companies and partnerships	Restriction necessitated by decision not to allow interest relief on borrowings by property investors; it was reversed from January 2002.
Section 250A (2004)	Restriction of relief to individuals on loans applied in acquiring interest in companies	Anti-avoidance provision.

3.2. In order to identify the objectives of the relief, it was firstly necessary to examine the Departmental files and the records of the Houses of the Oireachtas to see the statements that were made by the Government when introducing and amending these provisions. This is done to assist in determining the sector or economic subset that is or was being targeted.

3.3. Originally, the provision came into being as a 'carve out' from a relatively general restriction of personal loan interest deductibility for tax purposes. Until 1974 an individual could reduce their tax liability by claiming any interest paid on a personal basis (as opposed to a business basis) as a deduction.

3.4. From the Department's files it is clear the position was that personal credit was being used for speculative purposes and the tax relief being claimed in respect of the interest on the money borrowed for such purposes had reached very significant proportions. Steps were taken to address this.

3.5. The then Minister for Finance, Richard Ryan, in his Budget Statement on 3 April 1974, said that he had:

"*already announced that as from 10th January, 1974, the Finance Bill will restrict to a maximum of £2,000 a year the amount of interest on borrowings allowed to qualify for tax relief but that borrowings for genuine business activities will not be affected.*"[168]

3.6. The Minister for Finance further explained the steps taken as follows when introducing it in the Finance Act 1974. He said it related to the:

"*restriction of tax relief on loan interest. As the giving of tax relief on such interest effectively increases the burden of taxation on those who are not in a position to benefit from the relief, it is reasonable, in principle, to have a limit on the amount of non-business interest which may qualify for tax relief. The need for urgent action on the introduction of a limit became clear early this year when it was learned that a number of individuals with high incomes were abusing loan interest relief. They were borrowing large sums of money and, without regard to the consequential burden being thrown on other taxpayers, had used their borrowings in various tax avoidance schemes so as to reduce substantially or to nullify their own tax liabilities. To protect the general body of taxpayers, I announced that with effect from January 10, 1974 the amount of interest allowed to qualify for tax relief would be limited to £2,000 a year, but that borrowings for genuine business activities would not be affected.*"[169]

3.7. It is clear from these statements that the intention was to restrict relief for speculative personal borrowing without impacting on such borrowings for business purposes. In other words, in certain circumstances where personal borrowing are undertaken to support business enterprise, that interest could be used to reduce the tax one paid on one's personal income – with no limit.

[168] Dáil Éireann - Volume 271, Column 1442 - 3 April 1974
[169] Seanad Éireann - Volume 78, Column 1346 - 25 July 1974

3.8. This particular relief was introduced as an easement from the general crackdown on unrestricted relief for personal borrowings used for speculative purposes. Its purpose was to preserve unrestricted relief for personal borrowings to fund investments in companies where the borrower had, or was acquiring, an entrepreneurial interest in the company concerned. The borrowings were in effect regarded as analogous to business borrowings which were unaffected by the crackdown.

3.9. The philosophy was that interest on borrowed money (apart from that used in the purchase of one's home) would attract unrestricted interest relief only where it represented a business expense. Relief was not to be given where someone was acquiring shares in companies as a portfolio investment. Thus the relief was conditional on the claimant being a proprietor or employee of the company benefiting.

3.10. The relief changed a number of times over the years. The first major revision was section 8 of the Finance Act 1978 which removed conditions as regards having a material interest in the company (which was defined as holding 5 per cent of the issued ordinary share capital) and working for the greater part of the time in the actual management or conduct of the business of the company. This was relaxed to provide unrestricted relief to employees and directors, whether they are full-time or part-time in private trading companies, for interest on borrowing to acquire shares in the company.

3.11. In effect this removed the need for someone to be 'active' in the company and allowed 'passive' part-time directors to receive the relief. Additional relief of up to £2,000 interest to full-time employees and full-time directors of public companies who borrow to acquire shares in their companies was also introduced.

3.12. The then Minister for Finance, George Colley, spoke as follows about the scheme at Committee Stage of the Finance Bill 1978:

"*In general perhaps I should say that the basic reason behind the relief being given in this section is this. There are broadly two categories of people one can think about who can assist in the creation of jobs in this context. One is the man who is reasonably wealthy, and perhaps has a business or a profession, who is willing to invest a certain amount of his money in a business and take the chance on it. He will not be devoting anything like his full time to that business.*

He will be in partnership, perhaps, with other people and they will be engaging management and staff. If, as is normal in cases of that kind, he would borrow the money, although he would have the assets on which to borrow, and if he would not get any relief on the interest, he would in many cases decide that it was not worth his while at the cost involved to take the risk. I know of a number of cases where such people have made that decision. They were reasonably comfortable anyway and they felt it was not worth their while to take the risk when in the end it did not make a great deal of difference to their personal situation if they did not invest at all.

The object is to encourage people to invest in manufacturing or distribution or services and thereby create new businesses and, therefore, new jobs. That is the basic thinking behind it.

The other category of person involved is the manager, or managing director in some cases, of a company. In general, I am thinking in terms of people who are not terribly old but quite effective in business and whose services are, perhaps, sought by a number of businesses but who do not have a great deal of capital behind them. It is quite common for people like that to be offered as part of the deal when they are engaged share options in the business.

Of course, this is a form of incentive to them to build up the business and to the extent that they succeed in that they are increasing the value of the shares they have taken up. Such people, although they may have relatively high incomes, frequently have no real capital behind them and the main thing they have to sell is their entrepreneurial skill. In order to take up the share options they have to borrow money.

Such people are affected by the existing limitation and this section is designed to give relief in such cases so as to encourage this kind of development, which adds up, I believe, to a greater dynamism in different kinds of business and if we can get that it follows that we can get more jobs. That is the basic thinking behind the section."[170]

3.13. Section 14 of the Finance Act 1992 abolished the relief in the case of borrowings to acquire shares in quoted companies. It also provided that, in other cases, relief would not be given unless the loan was used for *bona fide* commercial purposes and not for reasons of tax avoidance.

3.14. The Minister for Finance at the time, Bertie Ahern, explained the change as follows at Second Stage of the 1992 Finance Bill:

"*The purpose of section 14 is clear. Quoted companies have access to the Stock Market for capital and should not need the assistance provided by this relief in raising it. In addition, quoted shares in general are valuable, tradeable assets. It is difficult to justify to ordinary taxpayers why they should provide a subsidy for their acquisition. This is especially so when, as the House is aware, interest relief for most people is confined to mortgage interest and is significantly restricted even for that purpose.*"[171]

3.15. In recent years the section has been visited by the legislators to enact anti-avoidance measures. Section 2 of the Finance (No. 2) Act 1998, section 16 of the Finance Act 2003 and section 22 of the Finance Act 2004 are all anti-avoidance measures which were designed to prevent the circumvention of the disallowance of interest relief for certain residential premises (a 'Bacon' recommendation), and to address certain contrived arrangements amongst spouses and between connected companies in the IFSC respectively.

[170] Dáil Éireann - Volume 307, Column 978 - 13 June 1978
[171] Dáil Éireann - Volume 418, Column 1789 - 28 April 1992

3.16. The then Minister for Finance, Charlie McCreevy, explained these provisions to the Oireachtas in the following terms:

Section 2 Finance Act 1998
"Section 2 is an anti-avoidance measure designed to prevent the circumvention of the measures in section 1 by channelling the borrowed moneys through a company or partnership. If this situation had not been catered for, a person could have obtained tax relief on interest on the borrowed money invested in the company or partnership which he or she could then invest in rented residential property."[172]

Section 16 Finance Act 2003
"Section 16, another anti-avoidance measure, counters contrived arrangements between spouses in relation to mortgage interest relief for investors." [173]

Section 22 Finance Act 2004
"I have stated previously that it is essential that tax avoidance schemes and loopholes are tackled vigorously. In a press release last March I made clear my intention to close a loophole which had come to my attention. It related to the relief available to individuals in respect of interest paid on money borrowed for the purposes of acquiring an equity stake in, or lending money to, a company where the moneys are used to acquire certain premises. This is provided for in section 22."[174]

3.17. This latter section addressed an avoidance scheme involving the purchase of certain premises in the Irish Financial Services Centre. With the reversal of the 'Bacon' proposal relating to interest relief for certain residential premises and the reintroduction of relief for such interest, the 1998 anti-avoidance measure was reversed by section 17(b) of the Finance Act 2002 with effect from January 2002, although it continues to apply to interest paid on such loans between 1998 and 2002.

[172] Dáil Éireann - Volume 491, Column 9 - 13 May 1998
[173] Dáil Éireann - Volume 561, Column 1277 - 19 February 2003
[174] Dáil Éireann - Volume 579, Column 1385 - 11 February 2004

4. ESTIMATED COST OF RELIEF IN TERMS OF TAX FORGONE

4.1. The Office of the Revenue Commissioners has a Statistical Branch which produces, *inter alia*, estimated costs of certain tax reliefs. The relief to individuals on loans used to acquire an interest in companies has been separately costed since the tax year 1994/1995. Up until then, it was combined in an aggregate total that included the cost of interest relief for loans to purchase a principal private residence, (i.e. home-owners mortgage interest). For years prior to 1994/1995, any cost estimates are based on the proportions that applied between mortgage interest relief and the 'miscellaneous' relief in question in that year.

Estimated Cost of the Relief, Numbers Availing and Average Claim Cost: 1994/95 - 2003

Year	Estimated Cost of Relief (€m)	Estimated Cost adjusted for shadow cost of public funds (€m)	Numbers Availing	Average Cost of Claim (€)
1994/95	8.3	10.4	5,720	1,450
1995/96	8.9	11.1	5,980	1,490
1996/97	8.3	10.4	6,200	1,340
1997/98	18.5	23.1	6,510	2,840
1998/99	18.4	23.0	6,600	2,790
1999/00	10.2	12.8	6,640	1,540
2000/01	13.0	16.3	6,840	1,900
2001	11.0	13.8	7,400	1,490
2002	15.6	19.5	5,260	2,430
2003	17.1	22.5	5,260	3,420

(Source: Office of the Revenue Commissioners)

4.2. These cost estimates are tentative and are understood to include interest relief permitted under other headings, such as on borrowings to pay death duties. These are estimated to be very minor sums as death duties were phased out in the mid 1970s.

4.3. These tax forgone cost estimates are prepared using an annual average marginal rate for income taxpayers and its weighting excludes those who are liable for income tax but are outside the net. However, as stated, it is an average figure and there are clear indications that those availing of this relief are primarily higher income earners. If a higher average marginal rate was used derived from information on the actual claimants, it is likely that these estimates would be increased by some 25%-30%.

4.4. On the other hand, it should be stressed at the outset that it is not reasonable to assume the estimated tax forgone would automatically accrue in full to the Exchequer if the relief were to be eliminated. There is little doubt that, in such a scenario, persons who wish to limit their overall liability to tax will examine their choices with a view to a migration of their investments. They will almost certainly alter their decisions and this includes taking steps to avail of any remaining tax-based schemes.

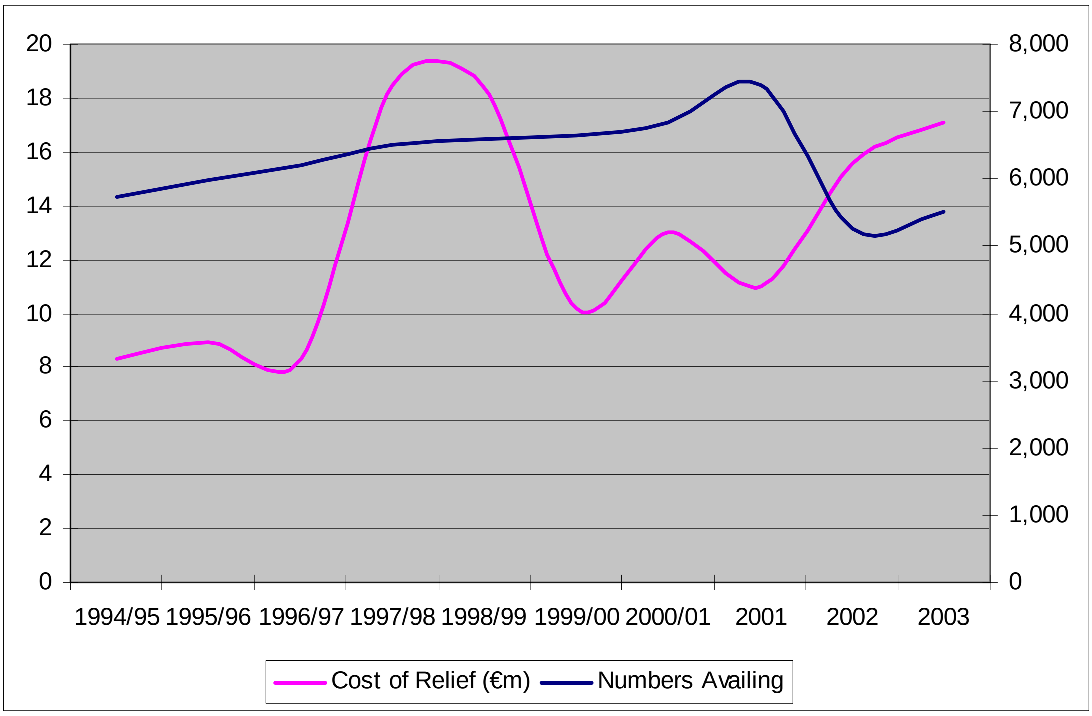
4.5. It is standard in cost benefit analysis to account for the economic impact of distorting taxation. This is because the cost of funding a public project includes both the extra tax revenue needed to fund the project and the economic cost of the distortions and disincentives imposed on economic activity by this extra tax.

4.6. In an Irish context, the project appraisal model used by the industrial development agencies historically used a shadow price of public funds of 1.5. This assumes the distortionary cost to be 50% of the value of the extra tax revenue. This has recently been decreased to 25% (a shadow price of 1.25) to take account of the reduction in marginal tax rates over recent years.

4.7. In the table above this shadow price of public funds is here used to estimate the tax relief cost taking account of the distortions that are created by the extra taxation that is imposed elsewhere in the economy to compensate for the loss of revenue due to the tax exemption.

4.8. The estimated cost figures shown in the first column of the table, given all of the factors explained in the foregoing, are considered reasonable estimates of the potential realizable gain for the Exchequer.

Cost of Relief and Numbers Availing: 1994/95 - 2003



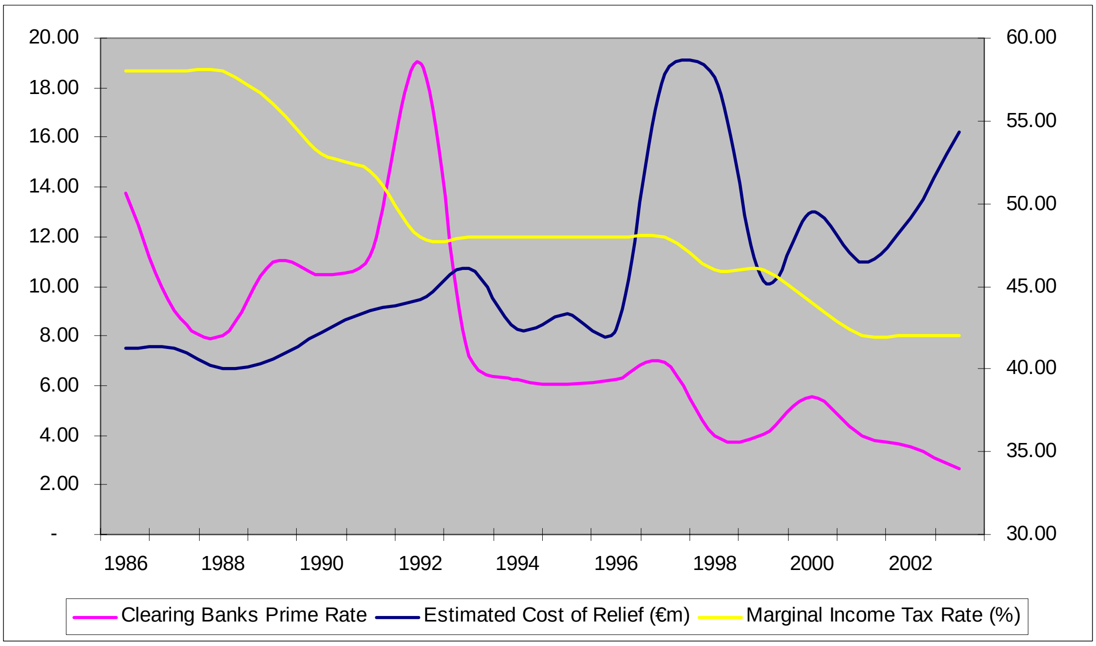
(Source: Office of the Revenue Commissioners)

4.9. This graph shows the cost of the relief in €m on the left hand axis and the numbers availing on the right hand axis for the last ten years for which we have data. It is clear that the overall trend in cost is upwards, with a significant ‘spike’ in the 1997-1999 period, which was marked by very rapid economic growth. The numbers availing fell away slightly between 2001 and 2002 but are increasing again.

4.10. The average cost of a claim is not especially high and the numbers availing appear to be modest. Nonetheless, other external factors which should have had an impact on the cost of the relief should also be looked at.

4.11. Over the period covered by the graph above the trends have been one of gradually falling interest rates, as the euro changeover occurred and Irish residents gained access to less expensive borrowing rates. There has also been a steady reduction in personal income tax rates during the time. Both of these elements should combine to push the trend cost in terms of tax forgone downward. Below is a graph which shows these elements against the cost of the interest being claimed since 1986.

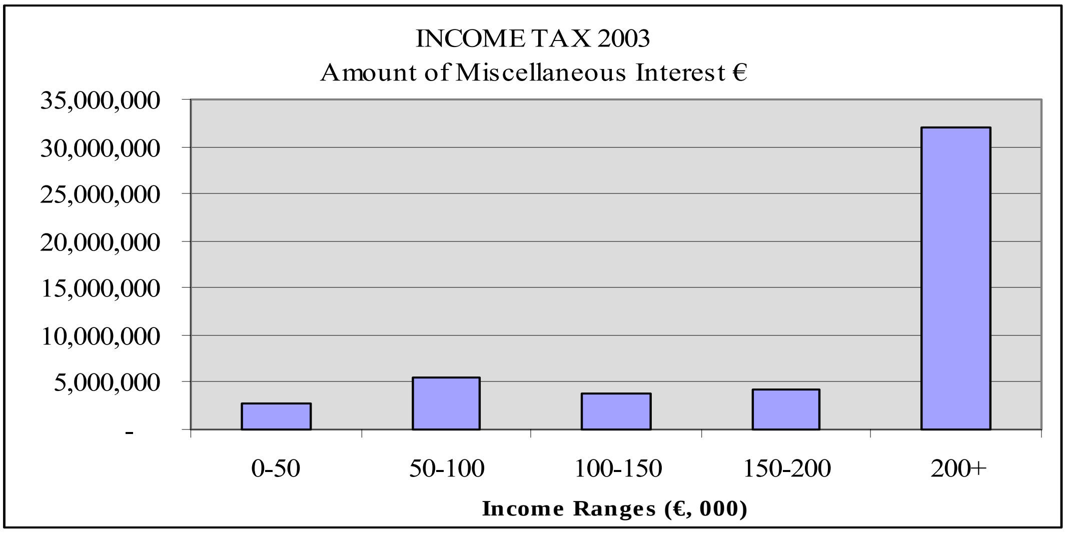
Comparison of Interest Rates, Marginal Tax Rates and Cost of Relief: 1985-2003



(Sources: Office of the Revenue Commissioners; Central Bank of Ireland)

4.12. It is clear that the cost of the relief is on a generalised upward trend whilst the fiscal and financial elements have been on a downward path. Given the numbers availing have remained fairly constant and have not displayed particular volatility, it seems plausible that the relief is used by a relatively small cohort. Assuming this is the case, it would seem the extent of its use is not wider but deeper, in that it is becoming more costly despite the underlying economic elements suggesting the contrary should be the case.

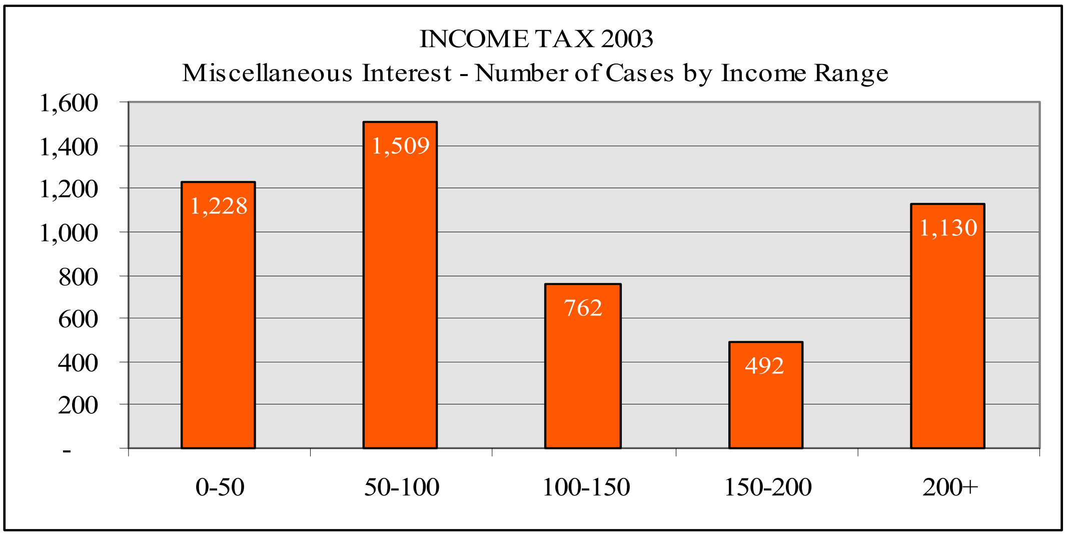
4.13. A fuller picture emerges when the relief is examined in terms of the income stratification of claimants. Below is a chart which shows the amount of miscellaneous interest being claimed in 2003, divided into income ranges with €50,000 as the interval. It is clear that the bulk of this relief is being claimed by those with incomes in excess of €200,000.



(Source: Office of the Revenue Commissioners)

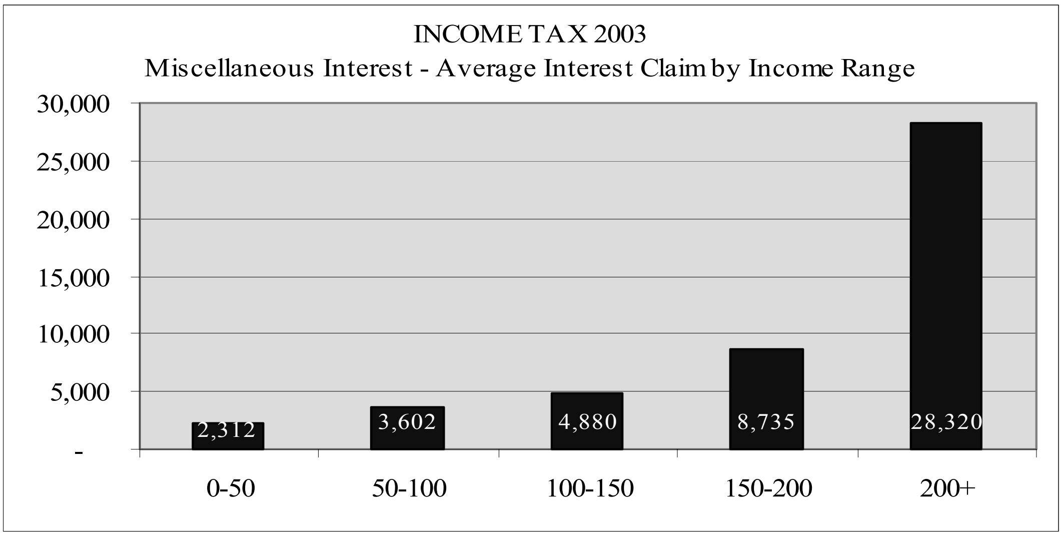
4.14. The chart which follows shows the number of claims being made for this interest relief within the same income ranges. This is given as a sample and the data shows a similar distribution when it is looked at longitudinally over the past seven years. This shows that there is a *prima facie* case to examine the record in equity terms and that the relief falls squarely within the terms of the review.

4.15. Indeed, the Revenue Commissioners study of individuals with high incomes that was completed for the short tax year 2001 showed 33 of the 115 individuals with high income levels (29% of the total) with an effective tax rate of less than 30% had used loan interest, sometimes *inter alia*, as a means of significantly reducing the tax payable. In 2002 of the 194 individuals with an effective rate of 30% or less, 47 claimed this relief, (representing 24% of the total). The total interest claimed by these individuals in 2001 was €3.5 million and in 2002 was €5.5 million. The declared income of these claimants in 2002 ranges between €145,000 and €17.8 million; the income related information is not readily available for 2001.



(Source: Office of the Revenue Commissioners)

4.16. The graph above shows the number of cases claiming the miscellaneous interest relief broken into the income ranges. The graph below takes the next step of showing the average claim per case, also split by the income ranges. The interest relief being claimed by individuals with high income levels, and those earning over €200,000 per annum are earning at least eight to ten times the national average, is substantially and significantly higher than those in the relatively lower income cohorts.



(Source: Office of the Revenue Commissioners)

4.17. For completeness and to give a contextual view, the position was examined with regard to those taxpayers who file using the Revenue On-line System (ROS). These ROS filers supplied additional information about this relief for the first time in respect of the tax year 2003.

4.18. The tables which follow give some summary details of the results from this dataset. The first thing to note is that the set is small, only 373 cases from some 5,100 claimants in that year (7% of the total). However, it provides one or two interesting pieces of information, such as that the average interest rate can be calculated as being 4.27% and only 4% of cases have an interest rate greater than 10%, so the rates being charged appear to be more or less in line with expectations.

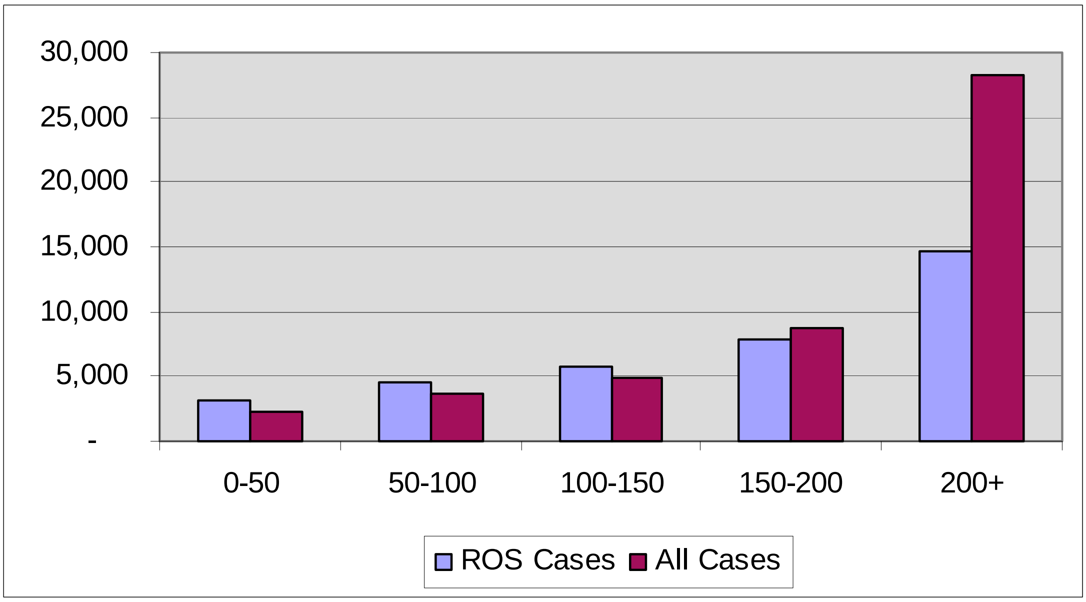
Total Amount of Loans (€)	Average Loan Amount (€)	Highest Loan Amount (€)
57,260,743	146,166	5,063,330

Total Interest Claimed (€)	Average Interest Claimed (€)	Highest Interest Claim (€)	Average Interest Rate
2,445,623	6,342	127,978	4.27%

INCOME TAX 2003 Cases with Miscellaneous Interest - by range of Gross Income. ROS Cases				
Range of Gross Income		Totals		
	From/To € K	Number of cases	Amount of Miscellaneous Interest	Average Interest Claimed
			€	€
	0-50	79	244,893	3,100
	50-100	114	516,492	4,531
	100-150	72	408,189	5,669
	150-200	44	342,403	7,782
	200+	64	933,646	14,588
	Total	**373**	**2,455,623**	**6,557**

4.19. The graph below shows, for each income range, the average interest claims for 2003 for ROS filers and for all filers. The quantum of claims is not quite as skewed towards the highest earners in the dataset as it is for the full sample. Therefore it appears the ROS filers are not representative of the profile of claimants as a whole in terms of income distribution (see graph below).

4.20. This may be because higher earners typically may have more complex business affairs and may file paper returns. This is because self-assessed taxpayers with a turnover in excess of €13 million must file a detailed paper version of the 'Accounts Menu' return even if they file on ROS. Therefore it is possible to speculate that these higher earners, as a proportion of the total filing population, are not using the online system in similar numbers, given the overall ROS filers comprise approximately 60% of the total.



(Source: Office of the Revenue Commissioners)

5. ECONOMIC EFFECTS AND FACTORS

5.1. In order to examine these elements the review aimed to:
- Look at overall trend in private company growth
- Look, if possible, at growth trend amongst companies whose directors or employees are availing of the relief
- Establish, insofar as may be, the industries/sectors in which private companies availing of the relief have been active and look to estimate overall displacement on sector or industry wide basis.

5.2. From the outset, it is clear that it will not be possible to measure accurately the contribution made by the existence of this relief in economic terms. Using Revenue-sourced data concerning the individuals claiming the relief and the nature of the businesses being supported by same, some general conclusions may be drawn about the relative success of the sectors in which those companies being supported by those availing of the relief were active.

5.3. To assist with this, the Companies Registration Office (CRO) was approached to provide the following data, insofar as it was available:
- the number of company formations and liquidations (specifically private companies) over time, say in last five years.
- numbers of employees in these companies (stratified)
- numbers of Directors in these companies (stratified)
- any available (gross) financial information - turnover, profitability, assets held, etc.
- information concerning the nature of business/sector the company operates in etc.

5.4. The CRO could only supply overall numbers of companies and not any of the other information sought.

5.5. In 2002 there were 2,450 proprietary directors who availed of the relief. In addition some may hold partnerships, although there are no figures available to say how many that may be. In 2002 there were 136,948 private companies on the register.

5.6. There is no limit on the number of directorships an individual may hold and theoretically the 2,450 directors could be connected to all 136,948 companies. There is a limit of 50 on the number of directors in a private company. Assuming each proprietary director availing of the relief holds five directorships in companies in respect of which s/he has borrowed to invest, there are 12,250 companies which may be receiving support, or some 9% of the total number of private companies. This is a not insignificant total.

5.7. The stated objectives of the relief are to relieve borrowings for normal business purposes and to encourage someone peripherally involved in a private firm to put up some risk capital as well as achieving a positive outcome in terms of job creation and it is these basic objectives that must be weighed up against any economic activity generated by the relief. Much of the following draws from the commentary contained in the mid-term evaluation of the National Development Plan.

5.8. The objective underpinning State aid to the productive sector in the past has essentially been one of employment creation. Against a background of high unemployment, it was clear that the benefits to the economy and to society generally of additional employment were positive. With this job creation objective in mind, a wide variety of strategies were employed, including the attraction of foreign-owned industry, the development of the indigenous industrial sector and other sectors such as agriculture, tourism and fisheries. The strategy was implemented through a wide array of support measures including capital and employment grants and assistance with marketing, training and research and development as well as by using tax incentives.

5.9. In the case of the domestic, indigenous sectors, the rationale underpinning these interventions rested on a view that due to various market failures and a generally unfavourable trading environment, the private sector would under invest in the absence of State intervention. The market failures included inefficiencies in the capital markets (i.e. financial institutions would not support "risky" ventures), distortions arising from the taxation system and information barriers (e.g. firms might be unaware of the benefits of training and research and development).

5.10. At the present time much of this rationale no longer applies. Firstly, the very rapid reduction in unemployment calls into question the need to subsidise job creation. Estimates of the shadow cost of labour are close to 100 per cent implying that the value to society of an additional job is minimal.[175] Secondly, many of the market failures outlined above have largely been addressed. There have been steady reductions in the tax burden, with marginal tax rates on labour on a declining trend.

5.11. Financial markets have been liberalised leading to increased competition and a change in mindset amongst the lending institutions. It has been argued, however, that there remains a financing gap for small start-up firms, typically seeking to borrow sums up to €250,000.[176] Start-up costs are relatively large but not large enough to make it worthwhile for financial institutions to risk assess individual prospective advances. In this scenario, there is an argument for state intervention but because the market failure is very specific it is widely accepted that the State should offer assistance in the form of a grant rather than a generalised tax relief.

5.12. In relation to information barriers, these have been overcome or, if it is claimed they have not, the effectiveness of the interventions employed to address them must be called into question at this stage. Furthermore, the environment facing the productive sector is now distinctly more favourable than that prevailing in earlier periods.

[175] In some locations, the value of an additional job may actually be negative as additional employment may give rise to negative congestion externalities, imposing costs on others. This is likely to be the case in Dublin at present.

[176] InterTradeIrelandSeedcorn funding report; PWC, August 2002

5.13. The productive sector has performed very strongly over recent years. Using the euro has brought patent benefits in terms of the elimination of exchange rate risk in trade with most of the EU and sharp reductions in the cost of capital. The Government has committed itself to a single rate of corporation tax since 2003. In addition, the distinction between the productive or tradeable sector of the economy and the non-traded sector is becoming increasingly obsolete.

5.14. These considerations require that, in order to make a case objectively for tax incentives, very precise market failure(s) need to be clearly established. As the National Development Plan commented: "*The Government … ….recognises that support for tradeable sector in the economy should be limited to measures designed to overcome identified market failures …*"

5.15. It must be acknowledged that a location or regional market failure rationale partly underpins some investment incentives but this is not a factor for this tax relief which applies throughout the State.

5.16. In this general context, this study has attempted to identify displacement, i.e. the possibility of the relief causing the displacement of other economic activity, and deadweight, i.e. the possibility of the desired economic activity having resulted anyway in the absence of the relieving tax provisions.

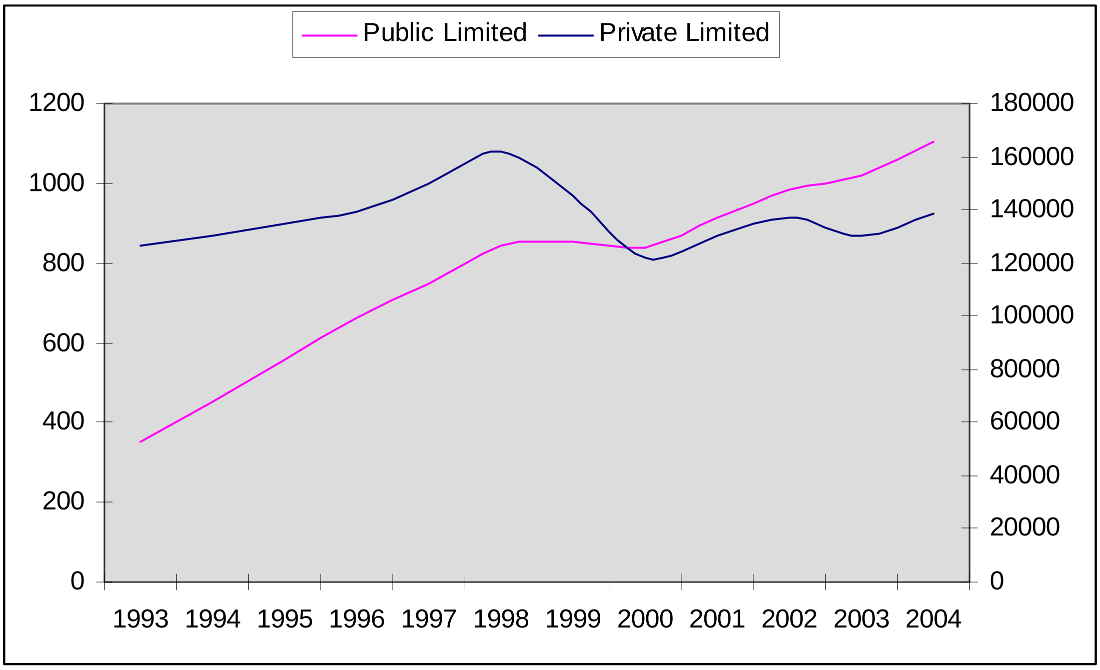
5.17. It has been understood from the outset that it would not be practicable to ascertain the extent to which displacement or deadweight has occurred in terms of an economic measurement exercise as the relief applies 'across the board' to private companies. However, it is intended to show deadweight occurs in the categories identified as benefiting from the relief and that this appears substantial.

5.18. Displacement occurs when economic activity created in response to the incentive occurs at the expense of existing activity. In practice, the concept is generally understood to refer to activity within the sector or area concerned (e.g. where some of the sales/business of, say, a new conference centre established with State support is taken from existing conference centres - thereby reducing the overall economy-wide impact of the centre).

5.19. More broadly, it can be argued that the rationale for the relief under review is to channel investment into what are seen as desirable areas and that therefore implicitly the scheme aims to displace activity into certain areas of the economy. However, as the interest relief applies generally to private companies, the question of whether or not the incentive has displaced activity within the area/sector concerned does not really arise.

5.20. However, it should be recognised that if the relief was to be confined to certain company types (i.e. to a sub-sector or sub-sectors within the overall sector), then the incentive is likely to lead to displacement from non-eligible areas. So any proposals to change the design of the incentive would have to be looked at carefully and a judgement made as to whether this was likely to give rise to significant and/or unwelcome displacement effects. The nature of the tax relief is such that the claimant may have a hands-on role and this might serve to temper the displacement effect, i.e. many people would not make the investment without having an actual involvement in the running of the business.

5.21. However, in order partially to gauge deadweight, the review has looked at growth in unrelieved sectors of the economy, a good example being the restriction of the relief to private companies in 1992. From examining these side by side, one can attempt to judge whether or not this change affected the growth of private companies vis-à-vis the growth of public companies. If their growth or decline paths were relatively unchanged then it can be argued the relief may not have been very effective.

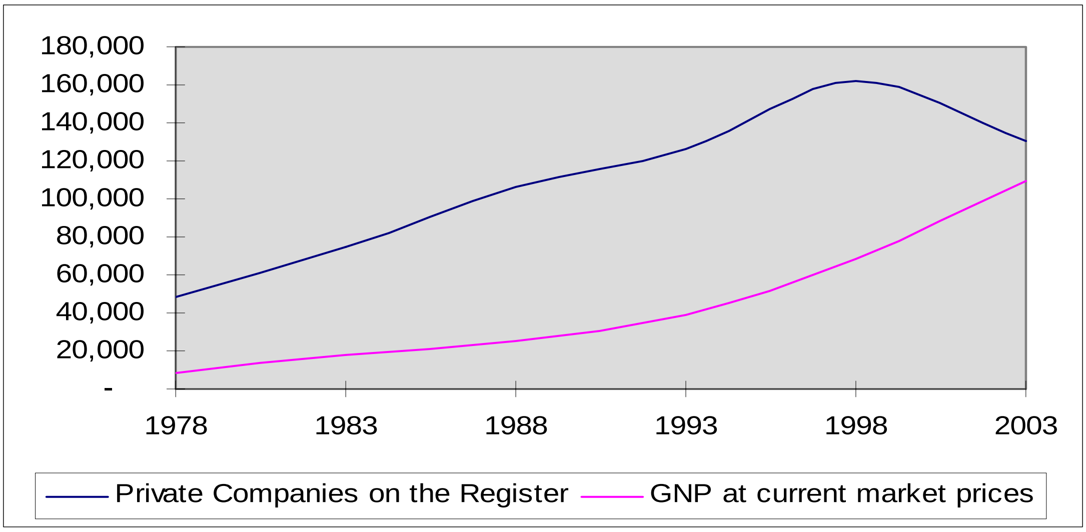


(Source: Companies Reports)

5.22. The graph above shows, against the left hand axis, the number of public limited companies and, against the right hand axis, the number of private limited companies.

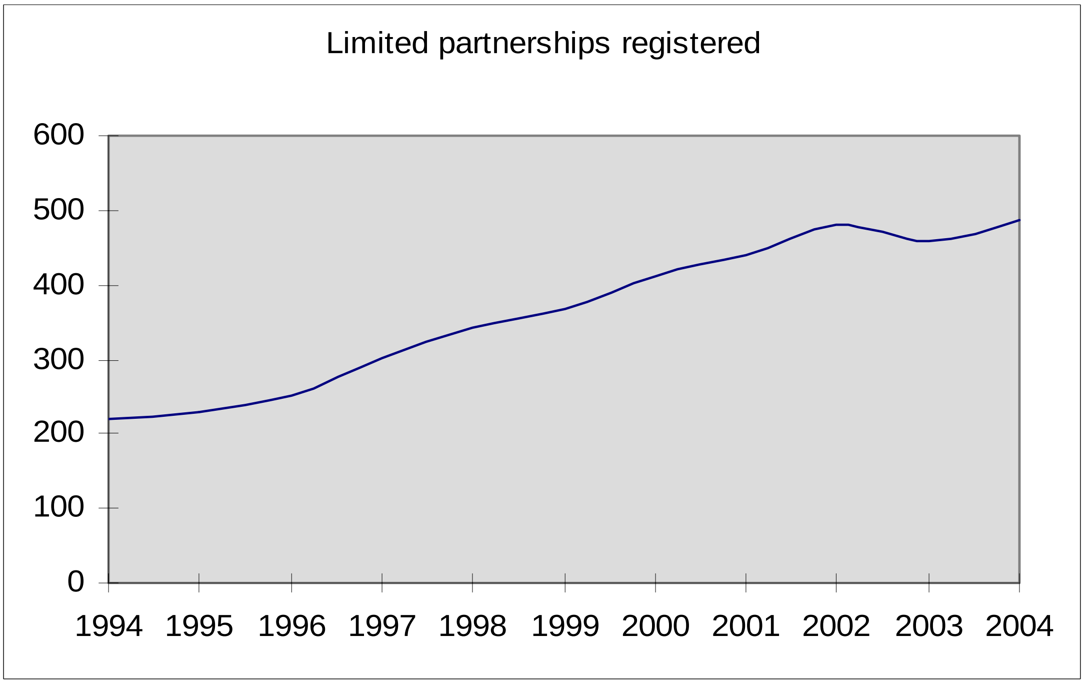
5.23. It should be noted that this comparison of private and public companies to estimate deadweight is fraught with difficulty for a number of reasons: firstly, because of the need to hold constant other factors which affect the growth of these types of company (e.g. historical industry structure, capital market integration etc.) and secondly, because the time period, starting in 1992, is possibly too short to allow formal statistical analysis.

5.24. What is clear is that there is no evidence of a detrimental effect on the growth on numbers of Public Limited Companies as a result of the restriction in the tax relief in 1992. However, the numbers of public limited companies may have grown faster and existing public limited companies may have grown larger if the relief had continued to apply.



(Source: Companies Reports)

5.25. The graph below shows that the growth in the number of private companies broadly mirrored the growth in the gross national product until the late 1990s when efforts were made by the Companies Registration Office (CRO) to remove dormant and non-compliant companies from the companies register. The fact that this CRO initiative has had no obvious dampening effect on GNP growth is also evident from the graph.



(Source: Companies Reports)

5.26. The picture with regard to unlimited partnerships is worse than that for companies as it is completely opaque. There are no figures available. Thus it has not been possible to estimate the numbers of partners who may have availed, or continue to be availing, of this relief. There are likely to be numerous partners in professional medical, legal and accounting practices availing of the relief, given the evidence from the breakdown of high income earning claimants by sector which is contained in the next section of this report.

5.27. The graph above shows there has been a doubling in the numbers of limited partnerships in the last decade but the information available is limited and of no meaningful use for this review, especially given the time and resource constraints under which it operates.

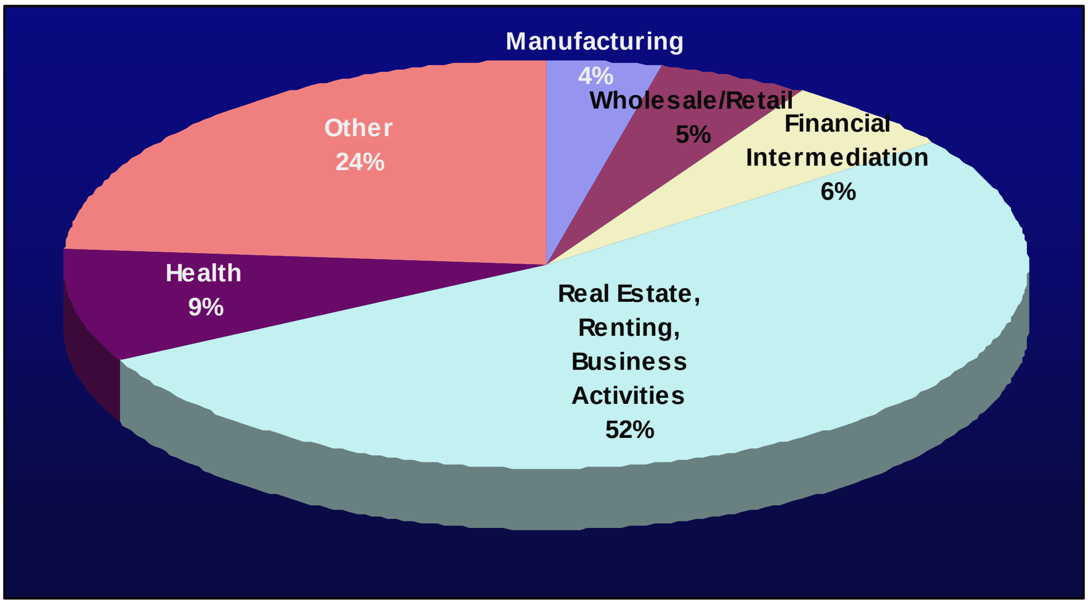
Examination and Comparison of the Sectoral Breakdown of Companies Connected to Relief Claimants with high earnings

5.28. While the review has shown that the relief is availed of by individuals with high earnings, it is not sufficient to simply illustrate this and then to say it should be curtailed solely on these grounds. It should be recognised that tax reliefs designed to encourage certain investments will of their nature have the effect of reducing the tax paid by individuals with high income levels. This is a straightforward trade-off and is widely understood.

5.29. Even where tax reliefs are beneficial, their desirability and feasibility must be considered in the context of the general direct tax system applying. For example, sustaining low direct tax rates requires a broad tax base. In order to gauge whether or not the relief represents a good use of public funds, it was decided to examine the business sectors being supported by the relief alongside those sectors being supported by funding from Enterprise Ireland. Enterprise Ireland is the national organisation with responsibility for accelerating Ireland's national and regional development by helping Irish companies to develop and grow. As such, it is possible to theorise that its client base should not be dissimilar to those availing of the interest relief.

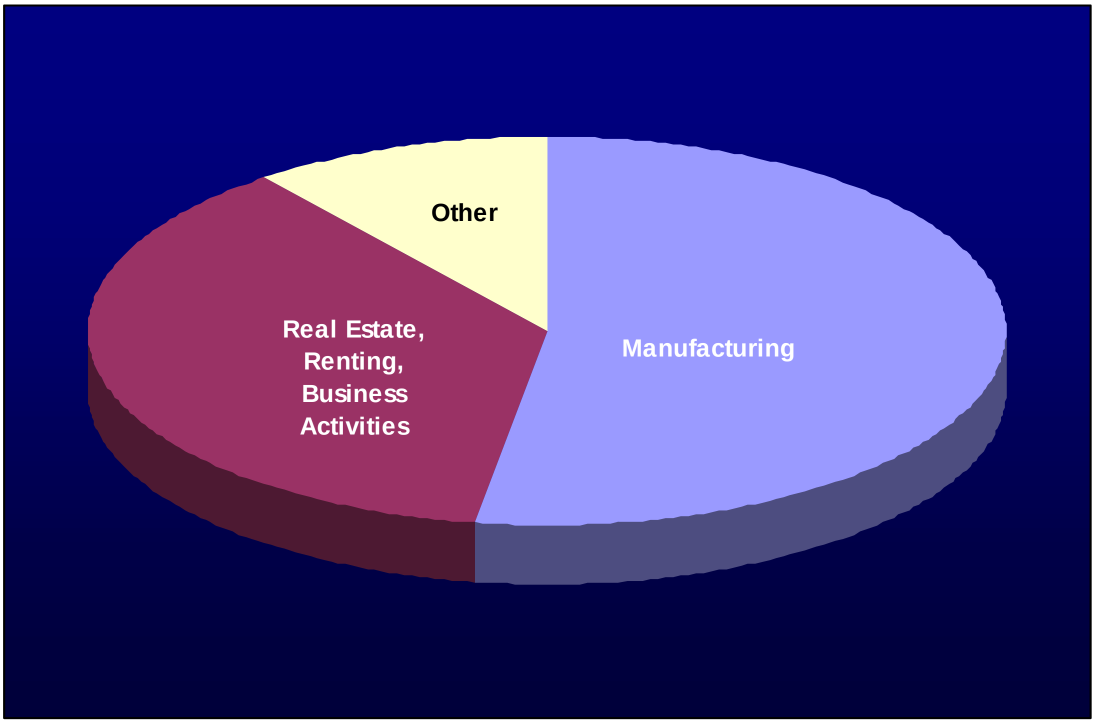
5.30. This part of the review was done with the kind cooperation of Enterprise Ireland and Revenue, both of whom supplied the relevant data referenced by the sectoral NACE codes. The positions are set out in the pie-charts hereunder. The Revenue set being examined was individuals claiming the relief who earned more than €150,000 in 2002 and numbered some 1,400. The Enterprise Ireland set was all those companies who had received funding between 1999 and 2005 and contained almost 4,000 entries.

Breakdown by Business Sector for Relief claimants earning over €150,000 in 2002



(Source: Office of the Revenue Commissioners; Department of Finance calculations)

Breakdown by Business Sector for those receiving Enterprise Ireland Funding between 1999 and 2005



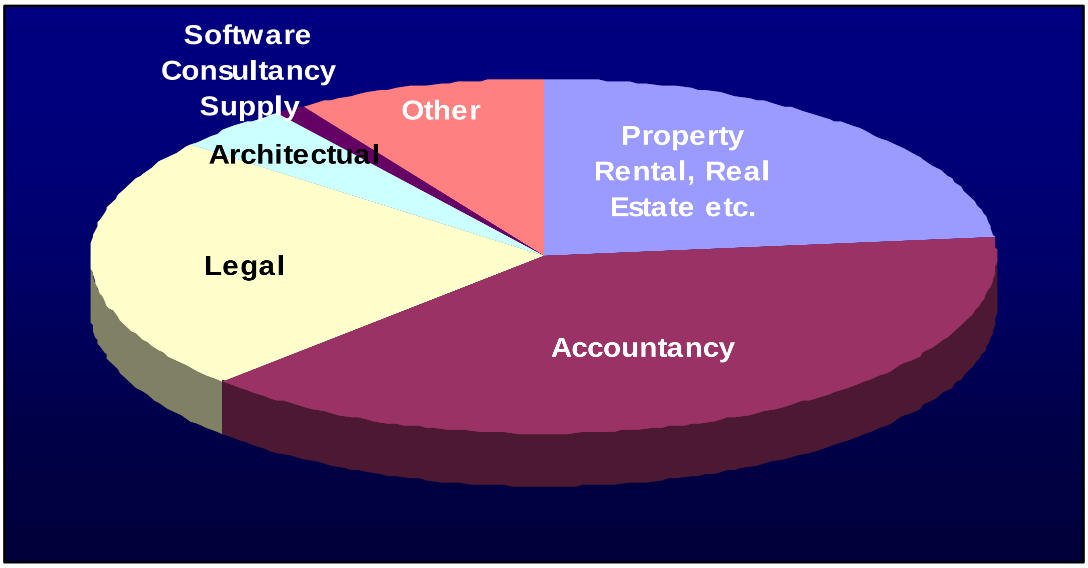
(Source: Enterprise Ireland; Department of Finance calculations)

5.31. It is immediately clear that the Enterprise Ireland (EI) funding is weighted towards the manufacturing sector. This is to be expected as EI has a focus on larger companies (which should have ten or more employees) operating in the internationally traded sector.

5.32. There is a broader spread of companies represented amongst the Revenue set of those claiming the relief. The size of the 'Other' category reflects this and also reflects the fact that Revenue uses certain NACE codes to record when directors take dividends from the company and in these cases the original code, if any, is overwritten.

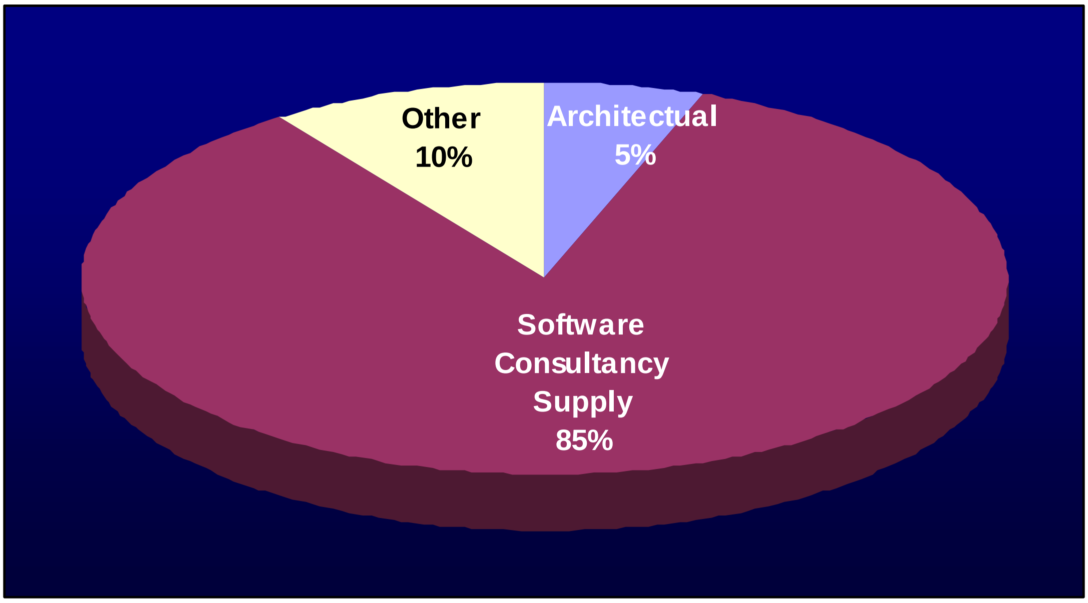
5.33. The largest element in the interest relief claimants set is in the 'Real Estate, Renting, Business Activities' sector and this is the second largest element of the EI set so these were compared to see what similarities could be found. It is also noteworthy that a significant proportion of the claimants (15% in total) are working either as medical practitioners, i.e. doctors or dentists, or in the field of financial intermediation.

Breakdown of 'Real Estate, Renting, Business Activities' Sector for Relief claimants earning over €150,000 in 2002



(Source: Office of the Revenue Commissioners; Department of Finance calculations)

Breakdown of 'Real Estate, Renting, Business Activities' Sector for those receiving Enterprise Ireland Funding between 1999 and 2005



(Source: Enterprise Ireland; Department of Finance calculations)

5.34. The picture here is stark, with EI funding primarily being aimed at software companies, whereas the tax relief is going to the professions in the form of accountants, legal practitioners and some architects as well as property developers and landlords. It should also be noted that whilst the claimant may be recorded as an accountant or architect etc. under the NACE code, s/he could derive significant income from other sources, including rental properties.

5.35. In summary the tax relief is being claimed by the service industry, primarily the professional classes, whereas the Enterprise Ireland funding is going towards manufacturing and software companies – in essence the traded sector.

Random Sample of Property Companies connected to Relief Claimants

5.36. Revenue supplied a list of 115 companies which are connected on the Revenue system to claimants of the interest relief, all of whom operate in the property sector and have declared income in excess of €150,000. Ten companies were chosen at random from this list and summary details of these as supplied by the Companies Registration Office are set out in the table following.

Company	Formed	Turnover (€)	Main Assets (Value €)	Directors (Other Directorships)	Main Liabilities (Value €)
A	1985	-	9 Properties (2.066m)	2 (8)	Creditors (0.597m)
B	1997	-	Investments (0.282m)	3 (8)	Creditors (0.281m)
C	1998	0.499m	Debtors (3.340m)	3 (22)	Creditors (2.788m)
D	1986	-	18 Properties (15.744m)	1 (4)	Bank loans (2.783m)
E	1986	-	5 Properties (56.246m) Shares (12.698m)	2 (192+)	Creditors (55.976m)
F	2001	-	3 Properties (10.683m)	2 (12)	Creditors (11.506m)
G	1973	-	33 Properties (3.513m)	4 (10+)	Bank loans (2.796m)
H	1997	-0.15m	2 Properties (18.800m)	3 (50+)	Bank loans (11.022m) Creditors (2.687m)
I	1995	1.843m	8 Properties (15.500m) Debtors (10.682m) Stock (40.524m)	2 (15)	Bank loans (47.934m) Creditors (10.794m)
J	1989	65.868m	17+ Properties (223.570m)	4 (200+)	Creditors (47.934m)

(Source: Office of the Revenue Commissioners; Companies Registration Office)

5.37. It should be recorded that these companies may not be the companies in respect of which the relief is being claimed. This is especially obvious when one has regard for the number of other directorships held by these principals.

5.38. Seven of the companies are, essentially non-trading companies holding assets in the form of property and these assets are balanced by bank debt and debt to other companies. The assets are generally carried in the accounts at their historical cost, which tends to underestimate their current market value. It is also evident that these seven companies are, in essence, engaged in property speculation in that they are not receiving rental income but are simply holding property as a trading asset. They are also substantial companies and are characterized, in general, by the complex nature of the corporate structures surrounding them and by what seems to be a disproportionately large number of directorships held by the directors.

Externalities or spill over effects.

5.39. To examine these effects the review attempted to (i) establish the industries/sectors in which private companies availing of the relief have been active and (ii) look to extract externalities from available industrial and/or sectoral data.

5.40. This proved difficult to achieve. All that can be said definitely is that certain externalities can be identified but a calibration of externalities against business related activities relying to a substantial extent on the existence of the interest relief would be doubtful in terms of meeting reasonable standards of academic rigour. Given the relief is being claimed by individuals who are coded as being active in the professions (e.g. legal, medical, accounting, financial intermediation) as well as by property developers, it is relatively certain that the relief does not give rise to widespread positive 'spillovers' or externalities. These sectors of the economy have grown over the period in question but this has been largely as a result of manufacturing growth and a growth in the traded sector.

Case study

5.41. A representative case study was not feasible, given the relief is currently only available to private companies and individuals availing of the relief could not be identified without their assistance and to do so would breach taxpayer confidentiality.

5.42. In addition, a survey was ruled out as unlikely to be effective or useful; there are some 140,000 private companies and only 5,000 or so individuals availing of the relief, not all of whom need be substantially involved in a company or companies, so it would not be a simple matter to cost-effectively source a meaningful survey set.

5.43. However the Large Cases Division in Revenue did provide an outline case study, which illustrates how the relief can be used to fund overseas property accumulation. This is set out below.

5.44. Structure of scheme:

- *18 individuals borrowed amounts of Stg£250,000 (€400,000) to Stg£1,000,000 (€1,500,000) each, which came to Stg£10,000,000 (€15,000,000) in total,*
- *They used the €15 million to acquire shares in a company incorporated in the British Virgin Islands,*
- *That company used €225,000 to buy a 25% interest in a property in Ireland that is let out,*
- *The income generated from that property investment, which is chargeable under Case V, is €22,500 per annum,*
- *The company used the balance of almost €15 million to invest in subsidiaries abroad,*
- *Those subsidiaries abroad invest the money in ventures abroad.*

5.45. The basis of the interest relief claim is that the company is “a company whose income consists wholly or mainly of profits or gains chargeable under Case V of Schedule D”. It is probable that the structure was chosen so that the profits from the foreign ventures will never reach the top company in the group structure. This ensures that both no Irish tax flows will result from the foreign income and also that the top company will never have any income other than the small Case V figure.

5.46. The overall annual cash-flow effect on the Irish Exchequer of this one case can be summarised as follows:

Transaction	€	€
Rental income	22,500	
Tax thereon at 25%[177]		5,625
Interest relief claimed €15,000,000 at 5%	750,000	
Tax relief thereon at 42%		315,000
Annual cost to the Exchequer		**309,375**

International Comparisons

5.47. The review examined the position with respect to tax relief for interest paid using resources available in the Revenue Library. The journals produced by the International Bureau of Fiscal Documentation are an important source of information. The countries whose regimes are described below are Australia, Canada, India, New Zealand and the UK.

Australia

5.48. In order for an interest expense to be deductible, the interest expense must have a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income and not be of a capital, private or domestic nature. There are restrictions and anti-avoidance provisions in place to counter non-commercial and contrived situations.

Canada

5.49. Interest must be owed pursuant to a legal obligation incurred for an income-earning purpose. The taxpayer must trace the use of the borrowed funds directly to the income-earning purpose. This means that borrowing being used to fund capital appreciation by way of land or property speculation would not be covered.

India

5.50. There is a liberal regime whereby all interest paid in respect of capital borrowed for the purposes of the business or profession is allowed.

[177] Corporation tax rate on non-traded income.

New Zealand

5.51. Interest is allowed insofar as it is necessarily payable in carrying on a business or is payable is deriving the taxpayer's gross income. Its deductibility depends on the use of the borrowed money to produce assessable income.

United Kingdom

5.52. The system that applied for income tax from its introduction in 1803 until 1969 provided a taxpayer with relief for all interest paid. Whether the interest was incurred as an expense in a business or a private capacity the taxpayer was permitted to retain a sum representing the income tax on that interest. This general relief was restricted in 1969 and henceforth for expenditure to qualify for relief as a business expense it must be incurred on revenue rather than capital account.

5.53. However, special reliefs apply to interest payable on loans related to investment in an individuals business. The relevant provisions are contained in s360 to s366 of the Income and Corporation Tax Act 1988, and the equivalent of s253 is s362. The position in the UK in relation to tax relief for interest on personal borrowings broadly mirrors the provisions of section 248 and 253 with the following differences:

(a) in the case of companies, the relief is confined to close companies (companies under the control of 5 or fewer participators or of participators who are directors) but excludes such a company which is an investment holding company,

(b) in the case of partnerships, the relief does not apply in the case of partnerships occupying commercial woodlands or which are property investment limited liability partnerships, and

(c) the relief also extends to interest on loans applied by full-time employees to acquire shares in a co-operative or an unquoted employee controlled company (more than 50% employees controlled) other than co-operatives and companies engaged in the occupation of commercial woodlands.

Summary

5.54. The general position in other jurisdictions is that interest is not usually allowed for loans used to acquire non-trading capital assets. The loans would usually be necessitated by the carrying on of a trading business.

Additional Restrictions - Tax Equity

5.55. Another question to be addressed was how the tax base could be broadened without affecting the favoured activities which are intended to be encouraged by the relief. This is of particular interest given the interest relieving provisions have been the subject of a number of anti-avoidance measures in recent years. The conclusions and recommendations section sets out the potential base-broadening measures that could be considered.

5.56. To address tax equity issues, the scale of the relief being claimed by individuals with high income levels has been examined. There is also the issue of how the relief is being used by individuals with high income levels as was illustrated by the Case Study. This is further highlighted by the guidance being proffered by tax accountants below:

Using an Irish resident company to own the foreign property may give the Irish resident shareholder an extra tax benefit in the form of an "interest as a charge" deduction against that individual's income. Irish law allows the Irish investor take tax relief on interest paid against any income where a loan is provided to a company who's (sic) greater part of income consists of Case V income. A problem arises because income from a foreign property is not taxes under this schedule however, we understand Revenue in practice have allowed an interest deduction where the properties are located in the UK and other EU countries.[178]

5.57. From the evidence adduced throughout the report, the relief is failing to meet reasonable standards of equity in terms of those claiming.

[178] Extract from presentation to ITI Tax Transaction Planning conference 26-28 May 2005 by Ms. Olivia Lynch (KPMG).

6. CONCLUSIONS AND RECOMMENDATIONS

Conclusions

6.1. The relief is primarily used by individuals involved in the professional field such as accountants, medical practitioners, architects, legal practitioners and by property developers or speculators.

6.2. There is no evidence linking the relief to increased employment or to it having any notable effect on economic growth. The restriction of the relief in 1992 so that it could not be used to acquire shares in publicly quoted companies had no discernable effect on the growth in their numbers since then.

6.3. The value of the relief is disproportionately distributed with the majority going to those earning over €200,000.

6.4. The estimated tax cost of the relief is increasing despite reductions in taxation rates and in rates of interest.

6.5. The companies which are benefiting from the relief are, in general, not those operating in the fields chosen to be actively supported by the State through Enterprise Ireland.

6.6. The scheme is out of line with international practice; only the UK has a similar provision and it is limited to close companies which are not involved in property investment.

6.7 While the relief has been the subject of recent anti-avoidance legislation, like all reliefs it can be the subject of tax planning attempts and there are some indications that tax planners are now turning attention to it to assist in the funding of overseas property acquisitions.

Recommendations

6.8 Given the conclusions set out above, it seems clear the relief should be changed. The recommendation is that this relief should be abolished or curtailed. If it were abolished the saving would be of the order of €17 million.

6.9 The options for curtailment and corresponding estimated savings are:

- Place a maximum on the amount of interest relief under section 248 and 253. Data available from the Revenue Commissioners suggests that if interest relief under S248/253 was restricted to the standard €31,750 the saving to the Exchequer would be of the order of €4 million.
- Allow relief only at the standard rate of income tax which would give a saving of some €9 million.
- Abolish the relief for investment in non-trading and rental companies, the estimated saving here would be of the order of €5 million.

APPENDIX:
RELEVANT PROVISIONS OF THE TAXES CONSOLIDATION ACT 1997

Section 248
In general, this section gives relief to individuals for interest paid on loans to acquire ordinary shares in, or to lend money to, certain "qualifying companies". Interest relief is not given on loans granted on or after 29 January 1992 to acquire shares in quoted companies. The relief is given by way of a charge in arriving at the individual's statutory or total income.

To qualify for relief under section 248 the following conditions must be met:
- the company must be a trading company, a rental company or a holding company,
- the individual must have a material interest in the company or in a connected company, and
- the individual employee/director must work on a full time basis in the company or connected company.

A private company means a company which by its articles:
- restricts the right to transfer its shares;
- limits the number of its members to fifty (excluding employees and former employees who hold shares in the company);
- prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Where the proceeds of a loan are applied in lending money to a company, relief is available only if the money lent is used wholly and exclusively for the purpose of the trade or business of the company or of a connected company. Relief is not granted if during the period from the application of the loan to the date the interest is paid, the company makes any loans or advances any money to the individual, unless the loan or advance is made in the ordinary course of a business, which includes the lending of money.

Finally, no relief is given for interest unless the loan is applied for *bona fide* commercial purposes and not as part of a scheme or arrangement having tax avoidance as its main purpose.

Section 250
Section 250 extends the relief available under S248 to certain individuals who do not satisfy the "material interest" test, or are not working full time for the company. By virtue of section 250 TCA 97, these restrictions do not apply to full-time and part-time directors and employees of private companies.

The section also extends restricted relief in the case of borrowings by full-time employees and full-time directors of a public company to acquire shares in that company. While the restrictions imposed by section 248 do not apply the relief is limited to interest amounting to €3,050 for a year of assessment.

The provisions of section 250 may be summarised as follows:

Individual	Unquoted Trading/ Rental Company	Unquoted Holding Company	Public Trading/ Rental Company	Public Holding Company
Full time working director/employee with no material interest	Unrestricted relief	Unrestricted relief	Max. relief €3,050	Max. relief €3,050
Part time working director/employee with no material interest	Unrestricted relief	No relief	No relief	No relief

There is no definition of public company in the Taxes Consolidation Act, however it is taken to have the same meaning as that assigned to it in the Companies Act 1963, i.e. any company which is not a private company within that Act.

Section 250A
Section 22 FA 2004 introduced a new section 250A TCA 97, which affects payment of interest made by individuals on or after 19 March 2003. The section applies where an individual borrows money and it is used by a company after 1 January 2003, directly or indirectly to acquire an industrial or commercial building which has a remaining tax life, from another company: to replace money used for such an acquisition or to pay off a loan used for that purpose. This section also applies to funds borrowed by an individual to pay off an earlier loan, which was used after 1 January 2003 by a company to purchase such a building.

Section 250A limits the claim for interest relief under section 248 TCA 1997, made by an individual whereby the interest relief cannot exceed the individual's return from the company in a year. An individual's return is the amount, if any, of interest and/or distributions received by the individual from the company in that year arising from the borrowed money used by the individual to acquire share capital or to give a loan to the company.

Section 251
Denies relief to individuals on loans applied in acquiring shares in companies where a claim for “BES relief” or “film relief” is made in respect of the amount subscribed for the shares.

Section 252
Abolishes relief on loans applied in acquiring interest in companies which become quoted companies.

Section 253
This section provides for unrestricted relief to be given to an individual for interest on money borrowed to enable him/her to acquire a share in a partnership or to contribute or advance money to a partnership. To ensure that the relief is confined to genuine

cases, the condition is imposed that the individual must, throughout the period from the application of the proceeds of the loan until the interest is paid, have personally acted as a partner in the conduct of the trade or profession carried on by the partnership. There are provisions to restrict the relief on the money borrowed where the individual has recovered any capital from the partnership.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section E:

Tax Relief for certain earnings of Writers, Composers and Artists – Section 195 of the Taxes Consolidation Act 1997

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1 – Executive Summary

1.1 The Minister for Finance announced in his Budget 2005 statement on 1 December 2004 that the Department of Finance and the Office of the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and tax exemptions in 2005. One of the exemptions to be reviewed was the Artists Tax Exemption.

1.2 The Artists Tax Exemption was introduced in 1969 to help create an environment in Ireland in which the arts could flourish and to encourage artists living abroad to come and live in Ireland. Under the exemption, income earned by artists, writers, composers and sculptors from the sale of their work (books and other writings, plays, musical compositions, paintings and sculptures) is exempt from tax in Ireland in certain circumstances. The exemption is only available to individuals who are resident or ordinarily resident and domiciled here for tax purposes and not resident elsewhere.

1.3 From the most recently available statistics, the exemption is estimated to cost €23.9m in 2002 (in respect of 1,600 claimants). Of the 1,540 claimants identified in detail for 2002:

- 1,323 claimed the exemption on eligible income in the range of €50,000 or less;
- 91 claimed the exemption on eligible income between €50,001 and €100,000;
- 100 claimed the exemption on eligible income between €100,001 and €500,000;
- 15 claimed the exemption on eligible incomes between €500,001 and €1m; and
- the remaining 11 claimed the exemption on eligible incomes in excess of €1m.

1.4 The top 26 claimants claimed the exemption on a total income of in the region of €39m with an estimated tax forgone of €12.93 million. The tax forgone in respect of the top 26 claimants represents almost 57% of the total tax forgone in respect of the 1,540 claimants. The statistics also show that these 26 claimants have paid a total of €0.75m tax on other non-exempt income in the same tax year. The tax forgone in respect of the majority of claimants availing of the exemption (i.e. 1,323 claimants), at incomes below €50,000 represents just over 10% of the total tax forgone under the scheme.

1.5 It can certainly be argued that the existence of the exemption has:

- helped create an environment in Ireland in which the arts could flourish
- encouraged new artists, and those artists on very low to moderate income to continue in their field, individuals who would otherwise have had to earn their income elsewhere
- encouraged artists living abroad to come and live in Ireland
- generated employment in terms of the support industry that has developed around the more successful artists and
- been beneficial for the arts in Ireland from both an economic and cultural perspective.

It is, however, difficult to measure many of these benefits.

1.6 The expertise of successful artists living in Ireland may help the performance of younger artists through the education system and other contacts in literary/musical circles. However, it is very difficult to quantify the extent, if any, of this interaction.

1.7 It is likely that the existence of the exemption has resulted in labour and capital moving to the arts sector from other economic sectors, thus the exemption may have given rise to some displacement both from other economic sectors and within the arts sector itself. The exemption may have had perverse effects on the structure of Irish art by providing an incentive for artists to engage in the artistic activities covered by the exemption at the expense of other artistic activities. However, it is not possible to measure the extent to which this may be the case.

1.8 Deadweight exists with regard to this exemption. Work of original, creative and artistic merit may qualify for this exemption but only a proportion of it will have been induced by the exemption. Thus a large part of the tax forgone will not produce a benefit. However, it is not possible to measure this deadweight.

1.9 Data on exemption relative to non-exempt income, at an individual artist level, for the tax year 2002 is set out in Table 9 of this Report. The statistics show that the top 26 claimants have paid a total of €0.75m tax on other non-exempt income in the same tax year which is low relative to the tax exempted of €12.93m. The explanation for this is not entirely clear. The small amount of taxable income being declared by the 26 persons in receipt of exempt income in excess of €500,000 might indicate the aggressive use of tax planning strategies by such persons in order to avoid exposing income earned abroad, and not covered by the exemption, to Irish taxation.

1.10 While statistics on the cost of the exemption and the amounts of tax being exempted by the top earning individuals can fluctuate greatly depending on the amounts they earn in respect of their creative work in a given year, it is understood from Revenue that in recent years a small number of high earning individuals are exempting well in excess of €1,000,000 on a near annual basis. Allowing this situation continue is difficult to justify on equity grounds no matter what the merits of the exemption are or the benefits derived from having these high earning artists reside here.

1.11 The Minister for Arts, Sport and Tourism, John O'Donoghue, T.D., has publicly supported the retention of the exemption without any change. The Arts Council also strongly supports the continuation of the exemption without change. Many submissions were received on the exemption from various interested organisations including many artists' representative bodies and individuals under the public consultation process. In the region of 100 representations, in the main from artists, in support of the exemption and over 1,640 representations via the Arts Council's website supporting the retention of the exemption without change were received. A summary of the main views on the exemption received from interested parties is set out in Section 8.

1.12 The main options for the future of the exemption are:

- to abolish the exemption entirely;
- to retain the exemption without change;

- to retain the exemption but introduce a cap on the amount that can qualify for the exemption perhaps combined with some form of income averaging system given the uneven nature of earnings by artists; or
- in the event that some form of “horizontal measure” is introduced in relation to restricting the extent to which those on high incomes can reduce their tax bills, to retain the exemption but provide that the exemption be covered by the “horizontal measure”.

1.13 Abolishing the exemption could make it financially difficult for artists in the lower income ranges to continue in their field and could have a long term impact on the development of the arts in this country. The statistics from 2002, highlighting the fact that the majority of artists are claiming the exemption on less than €50,000, support this view. In the circumstances, it is not recommended that the exemption be abolished.

1.14. However, there is a strong case, on grounds of equity, to restrict the amount of artistic earnings that can be exempted under the scheme given the fact that the statistics highlight that a relatively small number of individuals are claiming an exemption on very significant income.

1.15 Restricting the exemption may not result in any long term savings. It is the case that some high income earning artists may relocate outside the jurisdiction or put in place avoidance structures which mean that the income earned abroad will accrue to an entity which will not be liable to Irish tax. However, introducing a cap or restriction will address the inequity that exists in the scheme which currently allows a small number of individuals to exempt millions from tax.

2 - Introduction

2.1 The Minister for Finance announced in his Budget 2005 statement on 1 December 2004 that the Department of Finance and the Office of the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and tax exemptions in 2005. One of the exemptions to be reviewed was the Artists Tax Exemption.

2.2 This is a report on the review of that exemption. It has been prepared by the Department of Finance in consultation with the Office of the Revenue Commissioners. The report describes the exemption, explains the policy behind its introduction in 1969, and sets out the known costs and benefits of the exemption along with an evaluation of those costs and benefits.

2.3 The report includes a summary of the submissions received from the Department of Arts, Sport and Tourism, the Arts Council and from various interested organisations and individuals under the public consultation process.

2.4 The report also considers the exemption from an EU point of view.

2.5 Finally, the report examines the various policy options that could be considered in relation to the exemption.

3 - What is the Artists Tax Exemption?

3.1 Income earned by artists, writers, composers and sculptors from the sale of their works is exempt from tax in Ireland in certain circumstances.

3.2 Section 195 of the Taxes Consolidation Act, 1997 empowers the Revenue Commissioners to make a determination that certain artistic works are original and creative works generally recognised as having cultural or artistic merit. Accordingly, earnings derived from such works are exempt from income tax from the year in which the claim is made.

3.3 Guidelines have been drawn up by the Arts Council and the Minister for Arts, Sport and Tourism, with the consent of the Minister for Finance, for determining for the purposes of Section 195 whether a work is an original and creative work and whether it has, or is generally recognised as having, cultural or artistic merit. Revenue may, having regard to the Guidelines, consult with a person or body of persons which may be of assistance to them in reaching decisions in relation to Artists Exemption. A copy of the Guidelines is set out in Appendix 1.

3.4 Revenue can make determinations in respect of artistic works in the following categories:

(a) a book or other writing;
(b) a play;
(c) a musical composition;
(d) a painting or other like picture;
(e) a sculpture.

3.5 Confining the exemption to works in these categories means that income from the performing arts, for example, acting, dancing and musical performance does not qualify.

3.6 Claimants for the Artists Exemption must be resident, or ordinarily resident and domiciled, in the State and not resident elsewhere[179]. The Revenue Commissioners will give advance opinions regarding the exemption to claimants resident abroad. If these claimants receive a favourable advance opinion, they are given a formal determination in respect of Artists Exemption on taking up residence in the State.

3.7 A determination is generally made only once in any one category. The exemption which flows from the determination applies to all works in that category which would themselves qualify for a determination, if the subject of a claim for a determination. The artist is not required to submit other works in that category to Revenue for a determination provided the artist is satisfied that the other works come within the guidelines then in force. Where there is any doubt, the artist should submit the particular work to Revenue for a determination.

[179] An individual will be resident for a tax year if he/she is present in the State for a total of 183 days or more in the tax year, or he/she is present in the State for a total of 280 days or more in the tax year and the preceding year taken together.

3.8 The following payments are also exempt when made to a taxpayer who has received a determination under Section 195, Taxes Consolidation Act, 1997:

- Arts Council Bursaries.
- Cnuas payments made under the Aosdana Scheme.
- Payments from the sale of works abroad which come within the Guidelines set out in Appendix 1.
- Advance royalties.

3.9 Where a taxpayer receives advance royalties which are attributable to the subsequent publication of a book or other writing, a claim must be lodged with the Revenue Commissioners in the tax year in which the royalties are paid if the royalties are to be exempt. Confirmation from the publisher that the book will be published must accompany the claim.

3.10 Where a claim is received in the tax year in which the advance is received, but where a determination has not been granted, any tax liability arising on the advance must be paid. If a determination is subsequently granted, the Inspector of Taxes will review the taxpayer's liability and make any appropriate refund if tax has been overpaid. Advance royalties paid before the year of claim are not exempt.

3.11 All other income of persons qualifying for the exemption is liable to tax in the normal way.

4 - Background and Policy Objective behind the Exemption

4.1 The Artists Tax Exemption was introduced in Finance Act 1969 to help create a sympathetic environment here in which the arts could flourish by encouraging artists and writers to live and work in this country.

4.2 In introducing the exemption in his Second Stage speech on the Finance Bill to the Dáil, the then Minister for Finance, Mr Charles Haughey, T.D., said:

> *I would like to draw particular attention to section 2 which deals with the exemption from income tax of earnings of writers, composers, sculptors and painters. The purpose of this relief is, as I announced in the Budget Statement, to help create a sympathetic environment here in which the arts can flourish by encouraging artists and writers to live and work in this country. This is something completely new in this country and, indeed, so far as I am aware, anywhere in the world. We are entering a field in which there is no precedent or experience to guide us. It is a difficult undertaking because there are bound to be differences of opinion as to what constitutes a creative work and what has or has not cultural or artistic merit. We must, therefore, approach the matter in an empirical manner, feeling our way as we proceed, in a spirit of willingness to learn from experience and to adjust our arrangements from time to time in the light of that experience. I would ask, therefore, that people would not be unduly critical of our first attempt.*
>
> *The relief will apply to earnings from a book or other writing, a play, a musical composition, a painting or sculpture which is original and creative and which is regarded as having cultural or artistic merit. This question will be for adjudication by the Revenue Commissioners who may consult persons or bodies whom they consider competent to advise them. In view of the experimental nature of the measure, I am asking the Revenue Commissioners to be liberal in administering it and to give the benefit of the doubt where it arises to the writer or artist. I might add that the Revenue Commissioners have long been accustomed to seek expert advice on pictures, writings and other works of art for the purpose of the exemption of such articles from death duties under section 28 of the Finance Act, 1931. No particular difficulty has been experienced in the administration of that section*
>
> *It will be noted that the section provides that, once the Revenue Commissioners have determined that a particular work has artistic or cultural merit, the writer or artist will be entitled to exemption in respect of earnings from that work and all his other works in the same category. They will look to the status of the individual rather than to any particular work. In other words, the idea is that once an individual establishes that he is a creative writer, composer, sculptor or painter, his income from all his work in that capacity is free of tax. I expect therefore that persons who have already won general recognition in these spheres of artistic and cultural endeavour will qualify for the tax exemption on their reputation and that only a minority will be required to submit their work to the Revenue Commissioners*
>
> *I am convinced that we are right in making this attempt to improve our cultural and artistic environment and I am encouraged by the welcome given from all sides both at home and abroad to the principle of the scheme. I am hopeful that it will achieve its purpose.*

4.3 The introduction of the exemption was widely welcomed by the arts sector. Most artists, particularly the low earning artists, have a very uneven income stream. A creative work can take years to complete during which time an artist may have little earnings or have to engage in non-creative work to survive. There is also no guarantee that their creative work will be a success. The introduction of the exemption was seen as hugely supportive of such artists whose creative incomes were uneven and hugely unpredictable.

4.4 The introduction of the exemption was regarded as having increased the prestige of this country abroad. It attracted considerable positive media comment being loudly praised as enlightened and imaginative and proof of Ireland's interest in fostering the arts to the ultimate benefit and enrichment of society in Ireland.

4.5 The exemption also attracted some negative comment from the media and members of the public, mostly in that the exemption conflicted with the general principle laid down by Government that equivalent incomes should bear equivalent amounts of tax.

4.6 In an interview which Mr Haughey, T.D., gave to the Sunday Independent in April 1976, he commented that the exemption "is a long term project and I think it will take about 20 years to come to fruition". At the time, he dismissed any criticism of the exemption for conferring tax exemption rights on rich foreign authors and replied that if the concessions did not exist these people would not have come to Ireland in the first place and there would be no incomes to tax. He added "There is no loss at all to the Irish Exchequer and, in fact, if anything there is a net gain, for most of the people receive the bulk of their earnings from abroad and they also pay taxes of some sort or another to our community".

4.7 He added "The whole situation is absolutely and totally beneficial from our point of view".

Calls for changes to the scheme

4.8 Following the introduction of the exemption, the then Minister for Finance received many representations to broaden the scope of the exemption to include, for example, the earnings of actors and producers. These calls were consistently resisted. The Minister was of the view that the focus in relation to actors, actresses and musicians should be on trying to make sure that such performers could earn a living before the issue of whether they paid tax was addressed. He was of the view that financial assistance should be given to live theatre to provide plenty of employment for such performers and that tax concessions should be secondary.

4.9 Throughout the early seventies, proposals to repeal the exemption or at least to have its scope narrowed to exclude the earnings of journalists and writers of text books were examined on a number of occasions. Apart from the question of equity in granting this exemption to artists, it was Revenue's view that the exemption provided potential for abuse and that it had not resulted in any great influx of artistic personnel into the country. Despite this, no legislative changes were made to the exemption in the early years of its existence.

4.10 In the late seventies proposals were advanced to reduce the exemption to 50%. The main argument advanced in favour of this reduction was one of promoting equity in the tax system. While it was recognised at the time that the gain to the Exchequer from such a move would be minimal, it was suggested that the change could be justified in terms of its equity impact.

4.11 Revenue were of the view that such a reduction would not result in an exodus of artistic personnel from the country. Overall it was felt that the proposed reduction had the advantage of satisfying the demand for equity in the tax system without at the same time causing the emigration of foreign or native born artists.

4.12 The arguments against the reduction included that the Government would be open to a breach of faith in that artists who had made a decision to move residence and done so at some cost, could argue that the Government were going back on their original promises. It was also felt that a highly publicised emigration of some of the beneficiaries of the exemption could be represented as indicative of State indifference to the arts and could give rise to very damaging press both nationally and internationally. It was, however, felt that this could have been countered by allocating the amount saved from the reduction towards the Arts, for example, by way of scholarships for young artists.

4.13 The question of abolition or at least a reduction in the exemption arose again prior to Budget 1983. There was widespread rumour that the exemption was being terminated at that time. This led to a vigorous campaign from the artistic community. In the event, the Government decided against making any change to the exemption.

4.14 The exemption was again looked at in 1985. At that time Revenue suggested that consideration could be given to either abolition of the exemption or that, at least, some form of restriction should be introduced into the exemption. The alternatives suggested included:

(a) substituting a scheme of averaging artists incomes over say four years
(b) phasing out the exemption on a reducing percentage basis over a specified number of years
(c) setting a ceiling on the amount of income in any one year allowable for the exemption.

4.15 Again, the Government decided against making any change to the exemption.

<u>Commission on Taxation</u>

4.16 The Commission on Taxation in its first report in 1982 examined certain items of exempt income including the artists' exemption. The Commission stated that the existence of this relief was 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. It recommended the repeal of the exemption.

<u>Changes made to the exemption</u>

4.17 The 1969 scheme provided that to qualify for the exemption, the work must be original, creative <u>and</u> have cultural or artistic merit i.e. it should satisfy each of the three requirements. The words original, creative, artistic or cultural were not, however, defined in the legislation. However, as already noted, the intention was that the Revenue Commissioners should be liberal in administering it and to give the benefit of the doubt where it arose to the writer or artist.

4.18 The original intention of the legislation was that the exemption would not apply to income from books and writings such as text books, articles in newspapers, factual books which have little or no creative input from the author etc. Factual books and works of scholarship were not ruled out as such. In order to qualify for the exemption, however, it was considered that such work would have to be capable of being described as pioneering work casting new light on a subject and would have to be creative in the sense that the work was not merely one of facts, analysis and presentation but had been lifted onto a higher plane by the author's creativity.

4.19 Because of the lack of definitions in the legislation, the exemption gradually became extended to works which it was never intended to cover, in particular to text books and newspaper articles.

4.20 This development became more pronounced following the introduction of an appeals system in the 1989 Finance Act allowing applicants to appeal against a failure by the Revenue Commissioners to grant an exemption in respect of the relevant work. The problem was most acute in terms of factual books and text books. The Appeal Commissioners had ruled that text books on the Junior Certificate course and certain law books which were used and intended primarily as aids to professional practice and which contained no new facts or insights into their subject qualified for the exemption. The authors had been able to demonstrate that their works contained elements of originality and creativity by, for example, compiling information in written form for the first time – presenting information in a creative way or including commentaries by them on the subject matter.

4.21 Prior to Finance Bill 1994, the Minister for Arts, Culture and the Gaeltacht and the Revenue Commissioners proposed that action be taken to confine the scope of the exemption in line with the original intention.

4.22 The purpose of Section 14 of Finance Act 1994 was to remedy this situation by providing for guidelines to be drawn up by the Arts Council and the Minister for Arts, Culture and the Gaeltacht for determining whether a work qualified for the exemption. The guidelines helped re-focus the relief in line with the original intent. The guidelines, as set out in Appendix 1, were introduced in April 1995.

4.23 During the course of this review, there have been calls to retain the exemption; to introduce a cap on the amount of income that can qualify for the exemption; to abolish the exemption entirely; to broaden the scope of the exemption to include categories of artistic work that currently do not qualify and to amend the guidelines governing the exemption. These are all discussed in Section 10.

5 - Numbers availing of the Exemption

Statistics on the numbers of determinations

5.1 As mentioned previously, Section 195 of the Taxes Consolidation Act, 1997 empowers the Revenue Commissioners to make a determination[180] that certain artistic works are original and creative works generally recognised as having cultural or artistic merit. Revenue can make determinations in respect of artistic works in the following categories:

(a) a book or other writing;

(b) a play;

(c) a musical composition;

(d) a painting or other like picture;

(e) a sculpture.

5.2 Reliable statistics on the numbers of determinations granted by Revenue are available from the tax year 1995/1996 onwards. They are set out in Table 1 below.

TABLE 1 - Number of determinations granted between 1995 – 2004

Category		1995 - 1996	1996 - 1997	1997 - 1998	1998 - 1999	1999 - 2000	2000 - 2001	2001	2002	2003	2004	Total
(a) Book or other writing		137	84	72	96	90	88	79	86	92	110	**934**
(b) Play		52	32	39	27	40	35	28	28	26	32	**339**
(c) Musical composition		58	58	50	65	59	42	46	59	38	44	**519**
(d) Painting or other like painting		183	106	155	163	210	203	167	206	183	187	**1,763**
(e) Sculpture		37	41	50	63	81	69	49	59	36	44	**529**
Total		467	321	366	414	480	437	369	438	375	417	**4,084**

The tax years in the above Table run April to April up to 2001, April to December in 2001 and January to December thereafter.

[180] As one artist can be granted a determination in a number of categories of work, the statistics on the number of determinations do not indicate the actual number of artists who have been granted the exemption, although in practice, most artists receive a determination in one category only.

Statistics on applications from Foreign Nationals for Advance Opinions and the numbers of those subsequently granted determinations

5.3 The Revenue Commissioners will give advance opinions regarding the exemption to claimants resident abroad. However, detailed statistics on the number of foreign artists who have come here to avail of the exemption have not been kept until recent years. The most up to date statistics on applications from foreign nationals for advance opinions and granted a positive determination on subsequently becoming resident are set out in Table 2 below:

TABLE 2 - statistics on applications from foreign nationals for advance opinions

Year	Applications	No. granted Determinations on becoming Resident
2000	15	5
2001	18	5
2002	10	7
2003	13	3
2004	12	4

6 - Cost of the Exemption to the Exchequer

6.1 When the exemption was introduced in 1969, it was not possible to estimate the cost of the exemption but it was thought that it would be less than €127,000 (£100,000) a year.

6.2 Reliable statistics on the numbers availing of the exemption, the amount of income claimed as exempt and the estimated cost of the exemption in terms of tax forgone are only available from the tax year 1994/1995 onwards. Prior to 1994, the requirement to include exempt income in tax returns was not actively enforced and thus data held on file could not be relied on as complete. The most recent figures available relate to the tax year 2002. These data are set out in the table below.

6.3 Data on the numbers of individuals claming the exemption with a tax liability and the amount of tax paid on that non-exempt income are only available from the tax year 1998/1999 onwards. Again, the most recent data available relate to the tax year 2002. These data are also set out in the Table 3 below.

TABLE 3 – Cost of tax exemption and the amount of tax paid on non-exempt income from 1995 to 2002

Year ended	Numbers of claimants	Amount of income claimed as exempt	Estimated cost of tax exemption (tax forgone)	Numbers of claimants with a tax liability	Amount of tax paid on the non-exempt income of artists
5th April or 31st December					
As specified		**€m**	**€m**		**€m**
05/04/1995	520	17.9	6.5	n/a	n/a
05/04/1996	525	28.5	10.3	n/a	n/a
05/04/1997	700	36.5	13.2	n/a	n/a
05/04/1998	800	55.9	19.8	n/a	n/a
05/04/1999	900	73.1	24.5	425	7.3
05/04/2000	940	87.9	29.9	446	10.2
05/04/2001	1,200	119.1	37.1	536	9.9
31/12/2001	1,430	80.0	25.7	555	15.3
31/12/2002	1,600	78.5	23.9	822	13.8

6.4 The statistics in Table 3 indicate an increase in the numbers of artists availing of the relief and the amount of tax forgone. The above statistics indicate that since 1995 the numbers claiming the relief have increased significantly from 520 to 1,600 in 2002 (an increase of over 300%); the cost of the exemption has increased over the same period by even more from €6.5m to €23.9m (i.e. over 360%) with exempt income increasing from €17.9m to €78.5m (an increase of over 430%). Obviously the reduction in tax rates over the period has served to reduce the rate of increase in the tax cost.

6.5 The breakdown of the above annual statistics into income ranges of the claimants, however, indicates that most of the tax forgone under the exemption is in respect of a small number of artists with high incomes. These data are set out in tables 4 to 8 below for the five years 1998/1999 to 2002, the latest year for which information is available.

TABLE 4 - Income Tax year 1998/1999

Range of Exempted Income			
From	**To**	**Number of cases**	**Estimated Tax Forgone**
€	**€**		**€m**
	50,000	749	1.21
50,000	60,000	14	0.22
60,000	70,000	15	0.24
70,000	80,000	9	0.18
80,000	90,000	7	0.18
90,000	100,000	7	0.20
100,000	110,000	8	0.29
110,000	120,000	5	0.20
120,000	130,000	4	0.16
130,000	140,000	3	0.13
140,000	150,000	5	0.24
150,000	170,000	4	0.22
170,000	200,000	5	0.32
200,000	250,000	8	0.61
250,000	300,000	4	0.38
300,000	400,000	7	0.86
400,000	500,000	4	0.66
500,000	1,000,000	6	1.50
Over	1,000,000	13	16.70
Totals		**877**	**24.50**

TABLE 5 - Income Tax year 1999/2000

Range of Exempted Income			
From	**To**	**Number of cases**	**Estimated tax forgone**
€	**€**		**€m**
-	50,000	788	2.01
50,000	60,000	19	0.32
60,000	70,000	12	0.22
70,000	80,000	16	0.38
80,000	90,000	9	0.24
90,000	100,000	10	0.30
100,000	110,000	7	0.23
110,000	120,000	3	0.13
120,000	130,000	4	0.17
130,000	140,000	2	0.09
140,000	150,000	5	0.25
150,000	170,000	8	0.42
170,000	200,000	4	0.27
200,000	250,000	10	0.75
250,000	300,000	6	0.59
300,000	400,000	8	0.96
400,000	500,000	3	0.48
500,000	1,000,000	12	3.15
Over	1,000,000	15	18.95
Totals		**941**	**29.90**

TABLE 6 - Income tax year 2000/2001

Range of exempted income			
From	**To**	**Number of cases**	**Estimated tax forgone**
€	**€**		**€m**
-	50,000	1,029	2.23
50,000	60,000	25	0.37
60,000	70,000	19	0.34
70,000	80,000	11	0.24
80,000	90,000	14	0.32
90,000	100,000	10	0.26
100,000	110,000	7	0.23
110,000	120,000	7	0.23
120,000	130,000	3	0.11
130,000	140,000	6	0.23
140,000	150,000	2	0.08
150,000	170,000	10	0.51
170,000	200,000	15	0.88
200,000	250,000	6	0.43
250,000	300,000	7	0.62
300,000	400,000	11	1.29
400,000	500,000	6	0.85
500,000	1,000,000	4	0.85
Over	1,000,000	20	27.05
Totals		**1,212**	**37.10**

TABLE 7 - Income tax year 2001[181]

Range of exempted income			
From	**To**	**Number of cases**	**Estimated tax forgone**
€	**€**		**€m**
-	50,000	1,150	2.24
50,000	60,000	19	0.28
60,000	70,000	17	0.29
70,000	80,000	17	0.34
80,000	90,000	9	0.21
90,000	100,000	13	0.36
100,000	110,000	8	0.26
110,000	120,000	4	0.13
120,000	130,000	5	0.19
130,000	140,00	4	0.15
140,000	150,000	9	0.39
150,000	170,000	4	0.19
170,000	200,000	5	0.28
200,000	250,000	8	0.55
250,000	300,000	7	0.60
300,000	400,000	8	0.83
400,000	500,000	8	1.18
500,000	1,000,000	14	2.83
Over	1,000,000	14	12.18
Total		1,323	23.50

[181] It should be noted that as PAYE taxpayers were charged to tax on their earnings in the period from 6 April to 31 December 2001 and self-employed taxpayers were assessed to tax for the short year on 74% of the profits earned in a 12-month accounting period, data provided for the "short" tax year 2001 may not be directly comparable with those of earlier years.

TABLE 8 - Income Tax year 2002

From	To	Number of cases	Estimated tax forgone
€	**€**		**€m**
-	50,000	1,323	2.40
50,000	60,000	28	0.36
60,000	70,000	23	0.40
70,000	80,000	21	0.43
80,000	90,000	10	0.24
90,000	100,000	9	0.27
100,000	110,000	15	0.48
110,000	120,000	11	0.37
120,000	130,000	5	0.18
130,000	140,00	10	0.39
140,000	150,000	4	0.17
150,000	170,000	13	0.62
170,000	200,000	12	0.67
200,000	250,000	10	0.72
250,000	300,000	8	0.70
300,000	400,000	9	1.04
400,000	500,000	3	0.41
500,000	1,000,000	15	3.37
Over	1,000,000	11	9.56
Total		1,540	22.78

6.6 The above statistics highlight the fact that, in recent years, a relatively small number of individuals have claimed the exemption on very significant income.

6.7 Looking at the tax year 2002, the exemption cost an estimated €23.9m in respect of 1,600 claimants. Of the 1,540 claimants identified in detail in that year:
- 1,323 claimed the exemption on eligible income in the range of €50,000 or less;
- 91 claimed the exemption on eligible income between €50,001 and €100,000;
- 100 claimed the exemption on eligible income between €100,001 and €500,000;
- 15 claimed the exemption on eligible incomes between €500,001 and €1m; and
- the remaining 11 claimed the exemption on eligible incomes in excess of €1m.

6.8 However, the statistics also show that tax is being paid by those claiming the exemption on non-exempt income. The proportion of exempt to non-exempt income is roughly equal (€78.5 million exempt in 2002 as against €77.6m taxable). However, Table 9 shows that the bulk of the taxable income is declared by those claimants declaring under €50,000 in exempt income. In contrast, only €6.04 million (7.8%) of the €78.5 million of taxable income is declared by those claimants declaring exempt income in excess of €500,000. The implications of this are discussed further at paragraph 7.26.

6.9 In 2002, the top 26 claimants claimed the exemption on a total income of in the region of €39m with an estimated tax forgone of €12.93 million. The tax forgone in respect of the top 26 claimants represents almost 57% of the total tax forgone in respect of the 1,540 claimants. The statistics also show that these 26 claimants have paid a total of €0.75m tax on non-exempt income of €6.04m in the same tax year. Table 3 indicates that the amount of tax paid overall by claimants varies somewhat year on year with a general trend upwards but this cannot be extrapolated to the top 26 claimants. In fact Table 9 might indicate that these claimants, in 2002 at any rate, are managing their affairs in such a way that they are avoiding declaring most of their taxable income through use of tax planning. It is not unreasonable to assume that they are doing this "year after year". The tax foregone in respect of the majority of claimants availing of the exemption (i.e. 1,323 claimants), at incomes below €50,000 represents just over 10% of the total tax forgone under the scheme. In contrast, these same claimants pay 63% of the tax paid by all claimants on taxable income declared. A table showing the numbers of individual claimants, amount of exempt income and tax forgone by income level on a cumulative basis is shown below in Table 9.

6.10 In terms of the income statistics in the Table, it is not possible to say from tax records what percentage of the artists' income is foreign earned. It is known that the majority of the top 26 claimants are in the music industry. It is worth noting that a report prepared by Goodbody Economic Consultants in 2002 on the Economic Significance of the Irish Music Industry in 2001 noted that "major recording artists derive the bulk of their incomes from foreign record sales and touring abroad. In fact, it was estimated, based on the Interview Survey of the Top Twenty Artists, that as much as €244m or 97% percent of their income originates abroad. Other recording artists tend to derive lower proportions of their income from foreign sources, so that it is estimated that €249.5m or 93% of the income of all recording artists is earned abroad. For non-recording artists, all but a negligible amount of earnings will be domestic. Therefore €249.5m is also the estimated foreign earnings of artists as a whole. This means that the foreign earnings of artists amount to 60 per cent of the total earnings".

6.11. From the statistics and analysis set out in sections 5 and 6 it is possible to conclude that –

- the increasing number of claimants under the scheme would suggest that the scheme is working as intended in terms of encouraging artists to live and work in Ireland,
- the scheme may be providing an incentive to pursue an artistic career by persons who might otherwise not have had the opportunity to do so (this is particularly so for those claiming less than €50,000 as their primary means of earning a living is clearly taxable employment),
- while the scheme would seem to be a factor for some foreign nationals to take up tax residency in Ireland, the numbers doing so are relatively low (about 5 a year at most),
- the vast majority of claimants are using the exemption at reasonably low levels of exempt income and
- the exemption is being used by a very small number of artists with very high levels of exempt income and very low levels of taxable income possibly through tax planning.

Table 9 - Income Tax Year 2002 Distribution of Claimants by range of Exempted Income on a cumulative basis

Range of exempted Income Up To €	Number of cases	Amount of Exempt Income *€ m*	Estimated Tax Forgone *€ m*	Non Exempt Income *€ m*	Income Tax *€*
50,000	1,323	14.71	2.40	51.60	8,659,163
60,000	1,351	16.23	2.76	54.50	8,724,818
70,000	1,374	17.73	3.16	55.19	8,845,955
80,000	1,395	19.30	3.59	55.66	8,927,173
90,000	1,405	20.15	3.83	55.92	8,960,819
100,000	1,414	21.01	4.10	56.53	9,068,359
110,000	1,429	22.58	4.58	63.08	11,744,707
120,000	1,440	23.84	4.95	63.24	11,756,001
130,000	1,445	24.47	5.13	63.32	11,775,674
140,000	1,455	25.82	5.52	65.92	11,859,021
150,000	1,459	26.41	5.69	66.25	11,897,160
170,000	1,472	28.47	6.31	66.62	11,939,696
200,000	1,484	30.62	6.98	68.04	12,316,399
250,000	1,494	32.94	7.70	69.83	12,460,355
300,000	1,502	35.17	8.40	70.17	12,574,433
400,000	1,511	38.37	9.44	71.55	12,898,008
500,000	1,514	39.67	9.85	71.58	12,898,999
1,000,000	1,529	49.94	13.22	75.59	13,223,053
Over 1,000,000	1,540	78.47	22.78	77.62	13,632,306

7 – Benefits and evaluation of the Exemption

7.1 It can certainly be argued that the existence of the exemption has

- helped create an environment in Ireland in which the arts could flourish
- encouraged new artists, and those artists on very low to moderate income to continue in their field, individuals who would otherwise have had to earn their income elsewhere
- encouraged artists living abroad to come and live in Ireland
- generated employment in terms of the support industry that has developed around the more successful artists and
- been beneficial for the arts in Ireland and the wider community from both an economic and cultural perspective.

7.2 It is, however, difficult to measure many of these benefits and their actual impact, if any, on the economy in general.

7.3 **In terms of the exemption helping create an environment in Ireland in which the arts could flourish,** it is not possible to quantify the role which the exemption played. However, what we can say is that there is evidence that the number of artists in the country has increased, the quantity of creative work being produced has increased and the numbers of those availing of the exemption have increased.

7.4 The number of artists who are producing work has risen, as evidenced by the increased number of project proposals received by the Arts Council. In 1975, for instance, approximately 150 individual artists approached the Arts Council for assistance; by 2005 this had risen to approximately 1500.

7.5 Aosdana is an affiliation of creative artists, established in 1981 to support artists who have "…made an outstanding contribution to the arts in Ireland". The initial membership, based on an estimate of the number of artists who fell into this category, was 96. In 2005, this maximum membership figure was extended to 250 to reflect the increased activity within the creative arts.

7.6 The number of third level courses offering professional and vocational training in the arts has also increased. In 1975 courses were offered only at the National College of Art and Design and in the main campus centres of the University of Ireland. There are now dozens of courses on offer in both universities and private colleges.

7.7 The Revenue statistics and trends over the past 7 years or so give support to the argument that the exemption has made a significant contribution towards creating an environment in Ireland in which the arts could flourish. It is worthwhile bearing in mind that whatever about the merits or otherwise of the exemption, in order for an artist to get the benefit of the exemption he/she must first sell their product and the evidence is that an increasing amount of product is being sold by an increasing number of artists. Therefore, it is likely that the exemption helped increase the labour supply of Irish artists by providing a higher net return to additional artistic output of existing artists. This further increased supply may have increased the variety and quantity of Irish literature and music etc available for society to purchase. It is hard to quantity the extent, if any, of this increase and its resultant benefit to society

7.8 **In terms of the exemption having encouraged new artists, and those artists on very low to moderate income to continue in their field,** in the case of individuals who would otherwise have had to earn their income elsewhere or from other occupations, it is clear that the vast majority of such artists' incomes are low. This is borne out by the statistics. In 2002, 1,323 claimed the exemption on eligible income in the range of €50,000 or less on a total exempt income of €14.71m i.e. an average of €11,100 each. It is worth noting that the average industrial wage was €26,150in 2002.

7.9 In addition, income from artistic work can vary greatly from year to year and success is never guaranteed. Generally speaking, the majority of artists' creative income represents a number of years' work. Artists can go several years without earning anything on their creative work and have to undertake other forms of non-creative work to survive. The existence of the tax exemption on that creative income ensures the income stretches that bit further while artists persevere in generating their creative work. It also encourages artists to seek their income through their chosen art form.

7.10 Looking at the statistics from 2002, the 1323 individuals, who claimed the exemption on eligible income in the range of €50,000 or less, paid tax of €8.6m on non-exempt income of €51.6m i.e. an average income of €39,000 each. In other words, these artists are not high earners. During the review, many submissions and representations were received from artists in this income range. Virtually all claimed that given their level of earnings, it would be impossible for them to continue to practise their art without the existence of the exemption.

7.11 **In terms of the exemption encouraging artists living abroad to come and live in Ireland,** Revenue statistics on the number of applications from foreign nationals for advance opinions and subsequent determinations indicate that the existence of the exemption has at least being a factor in influencing some foreign artists to relocate in Ireland. In the tax years 2001 and 2002, of the 12 foreign nationals who applied for an advance opinion and were subsequently granted a determination on taking up residence in Ireland, it is known that 6 of the artists in question had incomes in excess of €100,000. This indicates that Ireland is attracting successful well established artists with substantial incomes and not just struggling artists.

7.12 These established foreign artists may be contributing to the economy in terms of the tax they pay on non-exempt income but again this cannot be measured. Once a foreign artist has taken up residence in Ireland, statistics on their exempt income and non-exempt income are recorded along with existing Irish artists. It is therefore difficult to disaggregate the exempt income and non-exempt income statistics on these foreign artists after they take up residence here. In addition, foreign artists would, in general, be entitled to the remittance basis of taxation and as they generally seem to be at the higher end of the income range it is actually very unlikely that they are exposing much taxable income to tax in Ireland. They would be more than able to live off their exempt income without remitting any other income to Ireland.

7.13 **In terms of the existence of the exemption resulting in employment in the support industry developed around the more successful artists**, such as galleries, theatres, music venues and recording studios, it is not possible to measure this. However, it can be assumed that the existence of the exemption has played some role in influencing the artist to generate the creative work which has generated the support industry around it. In so far as the artists service a domestic market more than an international one, it is not clear that that theatres, galleries and music venues would not have opened in the absence of the exemption. If an artist is selling to an Irish market he/she will have to access an Irish art gallery or an Irish theatre in order to get their art sold. For the small number of high earning international artists, it has to be assumed that the availability of the exemption has resulted in employment in the support industries developed around such artists.

7.14. Apart from the exemption, however, it is likely that other tax schemes within the Irish tax system have played their role in supporting artists and these other schemes, along with the exemption, are likely to have influenced the behaviour of such successful artists. In particular, the 12.5% corporation tax rate, the Business Expansion Scheme (for recording studios and internationally traded services such as media, multi-media, publishing, and entertainment and leisure services) and film relief (which likewise is anecdotally claimed to act as a factor in the establishment of such support type businesses).

7.15 **In terms of the exemption being beneficial for the arts in Ireland and the wider community from both an economic and cultural perspective**, apart from the economic considerations outlined above, it has been argued by the Arts Council and others that the existence of the exemption has contributed to the development of an enhanced arts culture in the country, the development of national identity and an environment to encourage the arts for future generations. Again, it is impossible to measure these benefits and while it is not unreasonable to argue that the exemption has played some role in this regard, there is no firm evidence to support the assertion.

7.16 The artists' exemption scheme ensures high productivity comparative to direct investment. The *per capita* direct spend on the arts in Ireland is low compared to the European norms (see Table 10) but, despite this, the level of artistic productivity, and indeed international success (e.g. four Nobel prize winners, numerous "Grammy" Awards, platinum album sales, etc.), compares well internationally.

TABLE 10. Survey of comparative arts spending in Europe: International Arts Bureau. 1999 figures

Country or Region	€ per Capita	as % of GDP
Sweden	79.16	0.350%
Finland	48.90	0.300%
Quebec	33.18	0.270%
Scotland	35.35	0.210%
Australia	32.87	0.190%
England	30.77	0.190%
N. Ireland	27.35	0.150%
Ireland	**13.15**	**0.090%**
USA	4.74	0.019%

7.17 The Arts Council submission also points to other socio-economic benefits to the country from the exemption including:

- that the exemption has raised the international profile of Ireland considerably and helped enhance Ireland's reputation of artistic vibrancy internationally. The success a number of high profile Irish artists including U2, Enya, Louis le Brocquy and Seamus Heaney and other successes such as "Riverdance" have helped in this regard.
- that the international profile has had favourable implications for tourism. A stronger reputation for Irish art, due to the increased supply of Irish art, may boost tourism and the possibility of attracting educated and productive employees to Ireland.
- that the exemption has assisted a proliferation of creative arts in Ireland, which while not all world standard, serves to enrich the lives of artists, their audiences and society at large; and
- that the local presence of Irish artists who have made it to the world stage is a source of very considerable inspiration to up and coming artists.

7.18 It is not possible to quantify these benefits but again it is reasonable to expect that the exemption has played some role in this regard.

7.19 The expertise of successful artists living in Ireland may help the performance of younger artists through the education system and other contacts in literary/musical circles – a possible trickle down effect. However, it is very difficult to quantify the extent, if any, of this interaction, and that the benefits of this interaction will accrue primarily to the younger artists – with some benefits to society at large through an increased quality of Irish art.

Displacement / Economic Cost of the exemption

7.20 It is likely that the existence of the exemption has resulted in labour and capital moving to the arts sector from other economic sectors, thus the exemption may have given rise to some displacement both from other economic sectors and within the arts sector itself. The exemption may have had perverse effects on the structure of Irish art by providing an incentive for artists to engage in the artistic activities covered by the exemption at the expense of other artistic activities. However, it is not possible to measure the extent to which this may be the case.

7.21 The economic behaviour of artists is distinctive, underpinned by a phenomenon termed "the creative imperative". The general trend for artists is to generate 'portfolio careers', which is a mix of employment to enable them to generate living expenses whilst being able to create work (these other incomes are of course taxed in the normal way). The Arts Council report on support for the individual artist in Ireland shows that "few artists can live on their art and many support themselves by taking other work". A quarter of the sample has to work outside the arts to get by; many others take non-creative work within the arts, for example teaching or critical writing.

7.22 Primarily this effect would be to encourage artists to switch from performance income which is non-exempt to producing 'works' of art which are exempt. This would reduce the supply of performing art in Ireland, increasing the price and reducing the amount and variety of performances. This would probably have a negative cultural impact on Ireland.

7.23 Another example of a displacement effect would be the extra incentive for academics to concentrate their research activities on books rather than journal articles. This affects the research output and related teaching duties of some university departments.

7.24 It also creates an incentive to switch from non-fiction writing to fiction writing, which is more likely to receive exemption.

Deadweight of the exemption

7.25 Deadweight exists with regard to this exemption. Work of original, creative and artistic merit may qualify for this exemption but only a proportion of it will have been induced by the exemption. Thus a large part of the tax forgone will not produce a benefit. It is not possible to measure this deadweight.

Tax being paid on non-exempt income

7.26 Data on exemption relative to non-exempt income, at an individual artist level, for the tax year 2002 is set out in Table 9. In 2002, the top 26 claimants claimed the exemption on a total income of in the region of €39m with an estimated tax forgone of €12.93 million. The statistics also show that these 26 claimants have paid a total of €0.75m tax on other non-exempt income of €6.04 million in the same tax year. The statistics vary from year to year but looking at 2002, the tax paid by the top 26 of €0.75m on income of €6.04 million (an effective average rate of 12.4%) is extremely low relative to the tax forgone of €12.93m on exempt income of €38.8 million (overall the average effective rate of tax of such persons on their exempt and non-exempt income of €44.84 million is 1.67%). The explanation for the low amount of taxable income is not entirely clear. The small amount of taxable income being declared by the 26 persons in receipt of exempt income in excess of €500,000 might indicate the aggressive use of tax planning strategies by such persons in order to avoid exposing income earned abroad, and not covered by the exemption, to Irish taxation. Furthermore, it flatly contradicts the argument put forward by the industry that the top earning artists are paying more tax on non-exempt income than the tax they would pay on their exempt income if it were to be subject to taxation.

<u>Amounts being exempted and the equity argument</u>

7.26 In 2002, the top 26 claimants claimed the exemption on a total income of in the region of €39m with an estimated tax foregone of €12.93 million. Indeed, while the statistics on the cost of the exemption and the amounts of tax being exempted by the top individuals can fluctuate greatly depending on the amounts they earn in respect of their creative work in a given year, it is understood from Revenue that in recent years a small number of high earning individuals are exempting well in excess of €500,000 and in some cases millions on a near annual basis. Allowing this situation continue is difficult to justify on equity grounds no matter what the merits of the exemption are or the benefits derived from having these high earning artists reside here. Tables 11 and 12 below show the number of claimants of the exemptions on artistic income in excess of €500,000 and €1 million in the tax years 1998/1999 to 2002.

TABLE 11 - Artists claiming the exemption on artistic income in excess of €500,000

Tax years	**No. of claimants**	**Amount of tax forgone €m**	**% of overall tax forgone**
1998/1999	19	18.20	74%
1999/2000	27	22.10	74%
2000/2001	24	27.90	75%
2001	28	15.01	63%
2002	26	12.93	57%

TABLE 12 - Artists claiming the exemption on artistic income in excess of €1m

Tax years	**No. of claimants**	**Amount of tax foregone €m**	**% of overall tax foregone**
1998/1999	13	16.70	68%
1999/2000	15	18.95	63%
2000/2001	20	27.05	73%
2001	14	12.18	52%
2002	11	9.56	42%

Looking at tax years 1999/2000 to 2002,

- 4 individuals feature in the top 10 in each of the four years and
- 7 individuals feature in the top 10 twice in the four years.

8 - Summary of views on the exemption received from interested parties during the course of this review

8.1 During the review of the exemption, the Department of Finance and the Revenue Commissioners met with the Department of Arts, Sport and Tourism and the Arts Council to discuss the exemption. The Department also received 40 submissions on the exemption from various interested organisations including many artists' representative bodies and individuals under the public consultation process[182]. Since the public consultation process concluded last July, the Minister for Finance has received in the region of 100 representations, in the main from artists, in support of the exemption. He has also received over 1,640 representations via the Arts Council's website supporting the retention of the exemption without change.

8.2 There has been considerable comment in the media and at the recent Oireachtas Joint Committee on Finance and the Public Service on the exemption. Much of the correspondence and commentary has been in favour of retaining the exemption without change.

8.3 All of the views expressed by individuals and organisations have been noted in the context of this review. This section summarises a number of the views expressed on the exemption during the review. The summaries should not however be taken to reflect all the views expressed nor as an endorsement of those views.

Views expressed by the Department of Arts, Sport and Tourism

8.4 The Minister for Arts, Sport and Tourism, Mr John O'Donoghue, T.D., has publicly supported the retention of the exemption without any change. In support of their Minister's position, the Department of Arts, Sport and Tourism has argued as follows:

- The position that Ireland affords its artists and the arts in general is renowned internationally and the exemption is important as a tangible expression of this approach.
- The exemption is enormously encouraging to Irish artists, increases the level of arts activity in the State and makes the life-choice difference for many artists when they reach the stage in their lives of choosing whether to stay with an artistic career.
- The absence of a cap on the exemption means that major international artists reside in Ireland and this has a positive impact on the vibrancy and vitality of the Irish arts scene; it facilitates mentoring, it provides role models for aspiring young artists.
- There are benefits for cultural tourism and the lifestyle choices made by such artists have a significant multiplier effect.
- Most of those benefiting from the exemption are very low earners and this should be viewed in the context of very uneven earnings profiles. Annual earnings can be very much lower when averaged out.

[182] This year's overall review of tax reliefs and exemptions included a public consultation process seeking submissions on measures that could be introduced to balance the benefit of such reliefs and the extent to which such incentives and exemptions are used by individuals with high incomes to reduce their tax bills. The consultation process inviting submissions was advertised in national daily newspapers on 8th January 2005.The deadline for submissions under the public consultation process was 31 March 2005.

- Government policy is to promote participation in the arts, and to facilitate, insofar as it is possible, professional artists to derive a viable income from the arts. Elimination of the exemption would reduce the level of professional arts activity in the State.

8.5 The Department of Arts, Sport and Tourism cautioned against any proposal to cap eligible earnings. It believes that high earners, particularly musicians will be likely to change their residences from Ireland, adversely affecting the vitality of the Irish arts scene. The Department also contends it would result in artists moving elsewhere and taking money out of the country, money that they would otherwise spend here.

8.6 The Department of Arts, Sport and Tourism makes the point that high earning artists generate over 90% of their income from activities outside Ireland and that Ireland only accounts for a very small part of the earnings of bigger international artists. It contends that because of the exemption, very substantial funds are channelled to, and accounted for, in Ireland. It believes that, if a cap is introduced, funds earned abroad will simply not be brought into the country.

<u>Views expressed by the Arts Council</u>
8.7 The Arts Council believes:-

- that the artists exemption should be retained in its entirety;
- that the exemption has made a major contribution to the creative arts in Ireland and delivered considerable socio-economic benefits to the Irish people as a whole;
- that withdrawing the exemption would be a major withdrawal of support for the individual artist;
- that abolition of the exemption would have negative effects of an economic and cultural nature;
- that abolition of the exemption, far from contributing to Revenue receipts, would very likely result in a decreased tax take from the arts sector.

8.8 The Arts Council is not persuaded that the public good would be served by transferring from the open market to the State the burden of providing to artists the income they would lose if the exemption were abolished. The Council points out that the exemption is the only State support for the Arts in Ireland which truly operates independent of Government and its agents.

8.9 The Council points out that the vast majority of artists who benefit from the exemption, in fact, earn very little from their artistic work. The Council is firmly of the belief that the example of high earning artists encourages young people to pursue a life in the arts, to the ultimate benefit and enrichment of society. It also points to the numbers of support personnel who find employment as a result of the presence in the State of world-class artists.

8.10 The Council also points out that the benefits of the exemption are felt also in non-artistic spheres and in an international context. It argues the commitment to developing Irish culture at the same time as developing a strong economy has been favourable for Irish tourism.

8.11 The Arts Council does not support the introduction of a cap on allowable earnings under the exemption. It believes a cap would yield little in terms of tax in the short term and would, in the medium term, drive out artists who have potential to make significant revenue contributions from non-exempt income. It also believes a cap would discourage, at the early stages of their careers, artists with potential for significant success. It points out that a capping formula which attempted to reflect equitably the variations in income that an artist can experience while he/she is generating his/her artistic work would be complex and possibly unmanageable.

Views expressed in submissions received through the public consultation process

8.12 The Department of Finance also received 40 submissions on the exemption from various interested organisations including many artists' representative bodies and individuals under the public consultation process. Almost all of the 40 submissions were in favour of the retention of the exemption although a number of them either acknowledged a need for the introduction of a cap on the amount of earnings that could fall under the exemption or actually recommended that such a cap be introduced.

8.13 In general, there was a consensus that the scheme should be retained as it:

- helped create an environment in Ireland in which the arts could flourish.
- encouraged new artists, and those artists on very low to moderate income to continue in their field, individuals who would otherwise have had to earn their income elsewhere
- encouraged artists living abroad to come and live in Ireland.
- was beneficial for the arts in Ireland and the wider community from both an economic and cultural perspective.

8.14 Copies of the submissions received can be found on the Department's website: www.finance.gov.ie.

9 - Are there similar incentives for artists in other jurisdictions?

9.1 No details were found of an artists tax exemption existing in other jurisdictions along the lines of the exemption in Ireland although many jurisdictions have a combination of financial supports such as grants, bursaries or limited tax supports available for artists.

9.2 In terms of tax supports for artists in other jurisdictions:

- There is an exemption from rates for artists in the Canadian province of Nova Scotia;
- In Rhode Island, New York, USA, there is an exemption from State tax on the income of artists from the sale of their work. This exemption does not, however, apply to federal taxes;
- Under the US/German tax treaty, visiting artists, athletes and similar performers enjoy their fees free of local tax if the total in any one year does not exceed US$ 20,000.
- In the United Kingdom, a grant is non-taxable if it is in respect of training schemes or to enable artists to devote time to research and development. All other grants are taxable.

9.3 While places like London, New York and Paris might be regarded as artistic hubs where artists tend to locate themselves for the purposes of being at the centre of their work, it appears that these jurisdictions are not providing any more favourable a tax regime for artists. In the circumstances, in reality, it is impossible to predict how many artists would locate elsewhere if the exemption were terminated.

European Dimension – State Aid issues

9.4 While the exemption has attracted considerable plaudits internationally since its introduction and is considered as an enlightened and imaginative piece of legislation fostering the arts in Ireland, it came under some criticism at European level during the seventies.

9.5 In 1976, the exemption was the subject of question by Mr Willy Dondelinger of Luxembourg, a socialist member of the European Parliament in which it was suggested that the Commission should ask the Irish Government to repeal this "immoral, unjust demagogic and unfair law". Mr Dondelinger also questioned whether the exemption was compatible with the Rome Treaties and its programme of fiscal measures.

9.6 The answer to Mr Dondelinger in October 1976 pointed out that the income tax legislation governing the exemption was not covered directly by the EEC Treaty. It added that the Commission in its action programme for taxation did not contemplate any harmonization measure that would result in the exemption being prohibited and that given the stage of European integration at the time, the Commission felt it must confine its work to a number of key economic and financial objectives. For these reasons, the Commission felt it was not in a position to take action in relation to the exemption. The Commission's answer noted that the exemption was granted on the basis of exclusive residence in Ireland but not restricted to Irish nationals.

9.7 The Department of Finance is not aware of the exemption attracting any negative attention at European Union level since that time and no State aid issue has been raised in relation to the exemption.

10 - Options and recommendations for the future of the Exemption

10.1 The main options for the future of the exemption are:

- (i) to abolish the exemption entirely;
- (ii) to retain the exemption without change;
- (iii) to retain the exemption but introduce a cap on the amount of income that can qualify for the exemption perhaps combined with some form of income averaging system given the uneven nature of earnings by artists; or
- (iv) in the event that some form of horizontal measure is introduced in relation to restricting the extent to which those on high incomes can reduce their tax bills, consideration should be given to retaining the exemption but providing that the exemption be covered by the "horizontal measure".

Option of abolishing the exemption entirely

10.2 It is a general principle of taxation that, as far as is possible, income from all sources should be subject to taxation. On this basis, it can be argued that artists' income should be subject to tax in the same way as other taxpayers' income.

10.3 It is Government policy to support the arts and it is generally accepted that the existence of the tax exemption for artists has helped create an environment in Ireland in which the arts could flourish. Abolishing the exemption entirely could be damaging to that environment, although it is not possible to measure the extent to which this would be so.

10.4 Abolition of the exemption could make it financially difficult for artists in the lower income ranges to continue in their field and could have a long term impact on the development of the arts in this country. The statistics highlighting the fact that the majority of artists are claiming the exemption on less than €50,000 support this view.

10.5 In the circumstances, it is not recommended that the exemption be abolished.

Option of retaining the exemption with / without change

10.6 As discussed earlier in this report, there is strong support from the artistic community and organizations supporting artistic endeavour for the retention of the exemption without change.

10.7 The Minister for Arts, Sport and Tourism, Mr John O'Donoghue, T.D., is of the view that the scheme has been extremely beneficial to the arts in Ireland and that it should be retained in its existing form. He adds

"It would be gravely mistaken to judge the scheme on the basis of perceived benefits to a very small number of high earners. Most of those benefiting from the scheme are on very modest incomes. Further, we have good reason to believe that terminating or even capping the scheme is more likely to result in high earners leaving the jurisdiction, or structuring their earnings in a way that avoids or greatly reduces any tax liability, than in any revenue windfall for the Exchequer".

10.8 Notwithstanding Minister O'Donoghue's comments, there is a strong case, on grounds of equity, to amend the exemption given the fact that the statistics highlight that a relatively small number of individuals are claiming an exemption on very significant income.

10.9 There is no reliable evidence to indicate that high earning artists will leave the jurisdiction although it is possible that they may or that they will, at least, engage in tax planning in order to minimise their tax liability. In the case of high earning artists, it is estimated that over 90% of their exempt income is foreign earned. It may be the case that this income will be diverted elsewhere with the result that the exempt income does not enter the economy in this country.

10.10 The case for amending the exemption to ensure that high earning artists can not exempt significant amounts is purely one of equity and it is on this ground that it is recommended that the exemption be amended. It should be noted however that amending the scheme may not result in any long term savings for the Exchequer.

10.11 Two ways in which the exemption could be amended to avoid high earning artists exempting significant amounts of creative income are by introducing a cap on the amount of earnings that can be exempted from tax under the scheme or by introducing a cap with a system of income averaging once the artist has claimed the exemption on a certain amount. These options are discussed below.

Option of introducing a cap

10.12 Introducing a cap would involve the placing of a straightforward annual limit on the amount of profits to be exempt. All profits above the threshold would be subject to tax.

10.13 There are no economic grounds for choosing the level at which a cap might apply. The level is one of judgement as to what would be regarded as an acceptable level of profits to be allowed exempt from tax. The Table below shows Revenue's estimate of the tax yield from a cap at various levels if applied to the 2002 statistics on the artists who claimed the exemption.

TABLE 13. Effect of proposed cap

Cap €	**Total number of claimants**	**Number of claimants in range**	**Number of claimants impacted on**	**Amount of income exceeding cap, €m**	**Potential Exchequer Yield from cap, €m**
1,000,000	1540	1529	11	17,529,712	5.8
500,000	1540	1514	26	25,798,369	8.5
200,000	1540	1484	56	36,649,230	12.0
100,000	1540	1414	126	44,847,734	14.5
50,000	1540	1323	217	52,907,599	16.8

10.14 As already mentioned, however, capping the exemption may not result in any long term savings as artists may restructure their affairs so that royalties from compositions and writings are diverted to a corporate or other structure (probably located off-shore). This of course only defers taxation as any draw down from the company would be taxable. The possibility arises, therefore, that such income becomes trapped off-shore. As stated earlier this may already be happening with such persons' taxable earnings. But while such tax planning may successfully shelter income from taxation as it is earned, it creates a difficulty in accessing the income. Any dividend or other payment from the company or other structure would be liable to taxation at the person's marginal rate. The result therefore is primarily one of deferring tax.

10.15 If the threshold figure were reasonably generous, the need for an income averaging system would not appear to be very compelling as the vast majority of cases would never breach the exemption threshold. Its application would, therefore, be confined to the minority with high earnings who constantly feature at the top of the exemption list and who because of a regular pattern of substantial exempt earnings are least in need of such a system. It is also likely that many of those with high incomes would be in a position to even out their earnings so as to maximise their benefits under the cap.

Option of introducing a form of income averaging

10.16 Another option would be to allow a form of income averaging for artists. While such a system might deal with fluctuations in income, there are however a number of disadvantages which would have to be considered. These disadvantages are considered below.

Disadvantages of introducing an income averaging system

10.17 There would be a number of disadvantages to introducing an income averaging system. The first question to be asked is would the scheme have to be confined to "full-time" writers and artists as is the case for farmers (the only other category for whom income averaging is available in the tax code). In effect there are very few of these as almost all would have other taxable income. If the scheme were not confined to full-time artists and writers, it would become more difficult to administer as different sources of income would require different tax treatment. The second difficulty relates to the commencement of the scheme. In year one, Revenue would have no profits for the preceding years to use in an averaging computation for artists. The third problem relates to the issue of artists and writers leaving the State or becoming non resident. Artists and writers are by nature involved in a profession which can involve high mobility and it is not uncommon for them to leave the State in any given year. In this way they differ considerably from farmers who are unlikely to leave their land. If an artist or writer leaves at the end of a period of income averaging it would be very difficult for Revenue to conduct the necessary review and issue assessments to recoup any tax due as a consequence of an artist having effectively opted out of averaging. There is also the issue that it could lead to calls from other categories of persons whose income are subject to variations from year to year e.g. performers and actors. Introducing income averaging against a background of exemption would mean that no material yield could be expected in the short term.

Recommendation
10.18 On balance, there is a strong case, on grounds of equity, to amend the exemption given the fact that the statistics highlight that a relatively small number of individuals are claiming an exemption on very significant income and that it appears the individuals in question are not paying what could be regarded as significant amounts of tax on their non-exempt income as discussed earlier in the report.

10.19 If a decision is taken to restrict the exemption to ensure high earning artists cannot year after year exempt significant sums under the scheme, it is recommended that a straight forward cap be considered. If the cap is placed at a high enough level, the rationale for linking it with income averaging reduces. Looking at 2002 statistics, given the probable complexity of such an averaging mechanism and the number of individuals likely to be subject to such a mechanism for calculating their tax liability, a straight-forward cap seems like the more reasonable approach.

Application of the "horizontal measure"
10.20 Finally, given the equity issue arising in relation to this exemption, should a "horizontal measure" be introduced in relation to restricting the extent to which those on high incomes can reduce their tax bills, consideration should be given to retaining the exemption but providing that the exemption be covered by the "horizontal measure".

<u>Other issues raised in relation to the exemption</u>
10.21 During the course of the review, there were calls to broaden the scope of the exemption to include categories of artistic work that currently do not qualify. There were calls to extend the exemption to the work of performing artists including actors and choreographers. As discussed earlier in the report, since the introduction of the exemption in 1969, there have been calls to broaden scope of the exemption in that way. The case for broadening the exemption, as proposed, is no more compelling than it was in 1969. The view held then was that granting a tax exemption to such artists should be secondary to providing direct funding to theatres etc to ensure more sustainable and varied employment for such artists.

10.22 There were also calls to revise the current guidelines which apply to the exemption to address certain operational problems that have arisen in relation to the exemption.

10.23 The review of this exemption has been carried out as part of an overall review of certain tax reliefs and exemptions with the aim of balancing the benefit of such reliefs and the extent to which such incentives and exemptions are used by high earners to reduce their tax bills. In this context, it is recommended that the exemption be retained but restricted in some form, as discussed above, on grounds of equity, given the fact that the statistics highlight that a relatively small number of individuals are claiming an exemption on very significant income. Examining the guidelines has not been the focus of reviewing the exemption. Assuming the exemption is retained, it is recommended that the current guidelines governing the exemption be examined to ensure that they are governing the exemption to the extent intended.

APPENDIX E-1

Guidelines drawn up under Section 195, Taxes Consolidation Act, 1997 by An Comhairle Ealaíon and the Minister for Arts, Heritage, Gaeltacht and the Islands with the consent of the Minister for Finance in relation to the implementation of Section 195.

Introduction

1. Guidelines were drawn up in 1994 to determine whether works falling to be considered under Section 195, Taxes Consolidation Act, 1997 are original and creative works and whether they have, or are generally recognised as having, cultural or artistic merit.

General

2. Section 195, Taxes Consolidation Act, 1997 provides that a work for the purpose of the Section is an original and creative work in one of the following categories:

   (a) a book or other writing;
   (b) a play;
   (c) a musical composition;
   (d) a painting or other picture;
   (e) a sculpture.

   Revenue may determine such a work to have, or to be generally recognised as having, cultural or artistic merit.

3. In broad terms, therefore, in order to secure exemption under Section 195, a work has to be both original and creative and to have either cultural merit or artistic merit.

4. In order to be granted a determination under Section 195, it is not necessary for a work to have both cultural and artistic merit - the presence of either quality is sufficient.

5. In applying these guidelines, Revenue may, as provided for in Section 195, consult with such person or body of persons as may, in their opinion provide authoritative assistance to them in establishing whether a work is a qualifying work for the purposes of Section 195.

Definitions

Cultural or artistic merit

6. A work has cultural merit if its contemplation enhances the quality of individual or social life by virtue of that work's intellectual, spiritual or aesthetic form and content.

7. A work has artistic merit when its combined form and content enhances or intensifies the aesthetic apprehension of those who experience or contemplate it.

"Original and Creative"

8. For the purpose of a determination under Section 195, Taxes Consolidation Act, 1997 the term "original and creative" encompasses any unique work which is brought into existence for the first time as an independent entity by the exercise of its creator's imagination.

9. A non-fiction work in category (a), a book or other writing, will be considered original and creative only if,

   (i) it comes within one of the categories cited in Appendix A, and

   (ii) the essence of the work is the presentation of the author's own ideas or insights in relation to the subject matter, and the ideas or insights are of such significance that the work would be regarded as a pioneering work casting new light on its subject matter or changing the generally accepted understanding of the subject matter.

Exclusions from the compass of "original and creative"

10. The following types of work in the categories set out in Section 195, Taxes Consolidation Act, 1997 will NOT be regarded as coming within the compass of "original and creative".

    (a) A Book or other writing, notwithstanding paragraph 9, above

    (i) A book or other writing published primarily for, or which is or will be used primarily by, students pursuing a course of study or persons engaged in any trade, profession, vocation or branch of learning as an aid to professional or other practice in connection with the trade, profession, vocation or branch of learning.

    (ii) An article or series of articles published in a newspaper, magazine, book or elsewhere - except a book consisting of a series of articles by the same author connected by a common theme and therefore capable of existing independently in its own right.

(b) A Play

Types or kinds of plays written for advertising purposes which do not exist independently in their own right by reason of quality or duration.

(c) A Musical Composition

Types or kinds of musical compositions written for advertising purposes which do not exist independently in their own right by reason of quality or duration. Arrangements, adaptations and versions of musical compositions by a person other than a bona fide composer who is also actively engaged in musical composition.

(d) A Painting or like picture

Types or kinds of photographs or drawings (other than a set or sets of photographs or drawings that are collectively created for an artistic purpose) which are mainly of record, or which serve a utilitarian function, or which would not exist independently in their own right by reason of quality or by reference to their potentiality for inclusion as part of an art exhibition.

(c) A Sculpture

Types or kinds of objects which are primarily functional in nature, objects produced by processes other than by hand, objects produced by hand by persons other than those actively engaged as bona fide artists in the field of visual arts.

Appendix A

Non-fiction categories applicable to be considered as eligible for a determination under Section 195.

1. The following categories of literature (and any combination thereof) coming fully with the terms of reference of the Arts Council encompassing the subjects of fiction writing, drama, music, film, dance, mime or visual arts, and related commentaries by bona fide artists:

    - arts criticism
    - arts history
    - arts subject works
    - arts diaries
    - autobiography
    - belles-lettres essays
    - biography
    - cultural dictionaries
    - literary translation
    - literary criticism

- literary history
- literary diaries

2. The following categories of works coming fully within the terms of reference of the Heritage Council including works which, in their entirety, comprise one or more of these categories:

   - archaeology
   - publications associated with items or areas of significant
   - heritage value

3. The following category of works coming fully within the terms of reference of the National Archives Advisory Council:

   - Publications which relate to the archives which are more than 30 years old concerning Ireland, and are based largely on research from such archives.

4. Categories of works which in their entirety comprise one or more of the categories cited in paragraph 1 to 3 above.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section F:

Tax Relief for Greyhound Stud Fees – Section 233 of the Taxes Consolidation Act 1997

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Note on Review of Tax Relief for Stallion Stud Fees

During the course of 2004 and 2005, the tax relief for stallion stud fees (as provided for under section 231 of the Taxes Consolidation Act 1997) was the subject of ongoing discussions between the Irish authorities and the European Commission, with particular regard to the State Aid aspects of the relief. In that context, the policy background to the tax scheme was considered. The Exchequer costs of this tax scheme could not be ascertained in the absence of relevant data (although, by virtue of amendments introduced in the 2003 Finance Act as regards the making of returns of income for tax purposes, such data should become available from spring 2006 onwards). No separate review of the tax scheme was in the event compiled by this Department. However, in the context of the consideration of the scheme, regard was had *inter alia* to the review conducted in July 2004 by economic consultants Indecon for the Irish Thoroughbred Breeders' Association, the European Breeders' Fund and Horse Racing Ireland[183]. In his 2006 Budget Statement, the Minister for Finance announced that the tax relief for stallion stud fees would be terminated with effect from 31 July 2008, and that a new regime appropriate to the industry will be discussed with the European Commission.

[183] Report available at http://www.horseracingireland.ie/industry_info/reports.asp

1. Introduction

The purpose of this report is to examine the nature of the tax relief provided under section 233 of the Taxes Consolidation Act, 1997, which exempts from income tax and corporation tax the profits or gains arising from the sale of service of greyhound bitches by stud greyhounds to the owners or part-owners of those stud greyhounds.

The report considers the extent to which the tax relief has justified its introduction and attempts to assess in broad terms the contribution the relief has made and can make to the wider policy objectives of the Government. The report also attempt to establish and assess the costs and benefits of the tax relief.

2. The Objective of the Tax Relief

This relief for greyhound stud fees was introduced in order to give parity of treatment with the tax treatment of thoroughbred stallions. The relief for stallions was introduced in 1969 and provided that profits from the stallion stud fees were to be exempt from taxation. Representatives of the greyhound breeding sector requested parity of treatment for greyhound stud fee income in 1995 on the grounds that it would prevent an ongoing decline in the number of greyhound breeders in Ireland. It was argued that the introduction of this relief would halt this decline and allow Irish breeders to have access to the best stud dogs from the United Kingdom, Australia and the United States. The argument was also made that many stud dog owners were withdrawing their dogs to bases in the United Kingdom and new entrants to the industry in Ireland would only be attracted in the right environment. The industry, argued that there was a need to attract many more people to ownership and that any obstacles (perceived or real) on the stud dog side of the business would be likely to considerably restrict expansion of the kind needed, given the commercial risks involved and the limited potential for the much sought-after prestige in owning one of the so-called "super sires".

3. Data Issues Relating to the Greyhound Breeding Industry

Any exercise is estimating the Exchequer costs relating to the greyhound stud fee tax relief is bedevilled by a lack of hard data. The original legislative provision under which the relief was introduced, section 25 of the Finance Act 1996, provided that the profits or gains arising from greyhound stud activities "shall not be taken into account for any purpose of the Tax Acts." Therefore there was no requirement on individuals or companies in receipt of such profits or gains to declare them for tax purposes and as a result no comprehensive income data are available at present from the Revenue Commissioners which would allow for an accurate estimate of economic activity in this area. The 2003 Finance Act provided that, in respect of returns due in respect of accounting periods commencing after 1 January 2004, persons in receipt of such income are required, as part of their 2004 tax return to specifically declare the income so that preliminary data should be available from the Revenue Commissioners from the end of October 2005 onwards.

It must therefore be concluded that, having regard to the lack of firm quantitative data, it is not possible at this time to determine accurately the cost of the tax exemption to the Exchequer, and that any estimate of cost must be somewhat tentative as it would have to be based on qualitative estimates and assumptions.

Data Examined

In view of the lack of statistical data on the profits and losses arising from the activity of greyhound studs, in order to arrive at an estimate the cost of the tax exemption to the Exchequer between 1996 and 2004 the following matters were examined –

- the number of male greyhounds registered as a sire for stud purposes in the Irish Greyhound Stud Book or in any other greyhound stud book recognised for the purposes of the Irish Greyhound Stud Book for each of the years in question

- the number of matings undertaken by each registered sire in each year

- an indication as to the stud fees charged for each mating by each individual sire in each year

- the estimated level of tax liability falling on persons in receipt of greyhound stud fees

- an indication of the aggregate associated stud activity costs incurred by persons in receipt of greyhound stud fees.

Sources of Data

The Greyhound Industry Act of 1958 established the Irish Coursing Club as the controlling authority over matters relating to the breeding (including registration and identification) of thoroughbred greyhounds and greyhound coursing in Ireland and established as one of the objectives of the Club the maintenance of the Irish Greyhound Stud Book which is published on an annual basis.

Each annual volume of the Stud Book shows a listing of all of the registrations of greyhounds with the Club, an index to dams and their produce, the names and addresses of the owners of the registered dogs, the names and addresses of owners of dogs who have registered transfers of ownership, an index to transfers of ownership and coursing results for the year in question. Each volume also sets out the aggregated numbers of registrations, transfers of ownership and registrations of litters in the year. Although the names of sires are printed in capital letters in the listings no aggregated information is provided in relation to the numbers of sires.

The registered progeny of each sire for the year is listed after the name of the sire but where sires are shown without a litter it does not necessarily mean that no mating took place that year. No specific numbers are provided for the numbers of matings.

It has not been possible to determine from an examination of the Stud Books the total number of greyhound at stud in the State as many of the owners whose dogs are registered in the books reside outside the Republic of Ireland, mainly in Northern Ireland and elsewhere in the United Kingdom. Bord na gCon have not been in a position to provide information as to the number of stud greyhounds registered in the Stud Books from addresses in this State. Without this information it is not possible to disaggregate non-resident registrations; for the purposes of this review it is assumed that all greyhound studs included in the Stud Books are standing in the State.

Number of sires

As previously indicated, the names of sires are printed in capital letters in the listings shown in the Stud Books but no aggregated information is provided. Many of the sires shown are registered to owners with addresses outside the State. Data received from the Irish Coursing Club indicates that the number of dogs at stud in 1994 stood at 518 while the number at stud in 2004 stood at 365. In the absence of information relating to the intervening years it is not possible to determine whether these figures are typical and it is therefore considered imprudent to draw any conclusions in relation to the effect of the tax exemption, positive or negative on the number of dogs at stud at this stage.

An examination of the internet site www.greyhound-data.com, which aims to provide information about greyhound breeding and racing worldwide, lists a total of fifty-five Irish breeding kennels. On the assumption that any serious commercial breeders are likely to wish to advertise their services on such a site, it seems likely that the number of commercial breeders in the state is fairly represented on that list. No stud fees are provided for any of the kennels listed.

Number of matings

Preliminary data from the Irish Coursing Club regarding the annual number of mating and registrations of pups is set out in Table 1 below.

Table 1 – Registration and mating data 1996 to 2003

Year	Stud Book	Number of Registrations	Change	% Change	Matings	Change	% Change
1995	Vol. 74	21,346	-		5,612	-	
1996 [1]	Vol. 75	21,910	564	2.64%	5,097	-515	-9.18%
1997	Vol. 76	20,250	-1,660	-7.58%	5,325	228	4.47%
1998	Vol. 77	19,565	-685	-3.38%	4,913	-412	-7.74%
1999	Vol. 78	20,012	447	2.28%	5,046	133	2.71%
2000	Vol. 79	21,019	1,007	5.03%	4,930	-116	-2.30%
2001	Vol. 80	20,694	-325	-1.55%	5,171	241	4.89%
2002	Vol. 81	21,371	677	3.27%	5,812	641	12.40%
2003	Vol. 82	24,847	3,476	16.27%	5,870	58	1.00%

[1] Greyhound stud fees exemption applies to profits or gains arising on or after 6th April, 1996

Source: Irish Coursing Club

It can be seen from Table 1 that there was a significant increase in the number of registrations in 2003; however it would be difficult to attribute any particular significance to this observation in the context of the tax exemption, given that a litter is not always either produced or registered in the case of each mating. What is of more significance is the number of matings over the period, and this figure has remained relatively constant with an average annual increase of just under 1%. This could lead to the conclusion that, of itself, the introduction of the tax exemption has had no significant effect on the average annual number of services by stud greyhounds.

Stud fees charged

Information received from sources within the Irish greyhound industry suggests that the stud fees commanded by sires are in the ranges set out in Table 2 below.

Table 2 – Stud fee ranges 1994 to 2004

	1994	**2004**
General stud fee range	€254 - €381	€300 - €800
Top 10 stud fee range	€508 - €635	€1,500 - €2,000
No. of litters from top ten	8 - 100	185

Source: Irish greyhound industry sources

Assuming that the above figures are correct it can be seen that at the lower end of the range the general stud fee range has remained relatively static over the 10 year period shown with a just over 100% increase at the top end of that scale. By contrast there has been an almost 200% increase in the top ten stud fee at the lower end of the range with similar increases at the top end of the range.

Although inflation rates have remained at relatively low levels over the ten-year period covered in Table 2, no clear conclusions can be drawn from the increases in stud fees shown. Given the relatively modest increases in the general stud fees in comparison to those available to the top ten dogs, the conclusion might possibly be drawn that the value of successful dogs has increased with the increasing popularity of the sport but that the value of all other dogs has remained relatively constant. If this is accepted then it must also be concluded that whatever increased profits or gains have arisen from stud dogs as a consequence of the increased popularity of the sport over the period have accrued to a small number of stud dog owners only.

It is interesting here to compare the stud fees quoted above for 2004 with details of stud fees for a number of Australian stud dogs listed on the internet, as set out in Table 3 overleaf.

Table 3 – Australian greyhound stud fees July 2005		
Stud fees are shown in Euro equivalents		
€ Stud fee range	**Number of dogs**	**% of total**
0 - 249	1	2%
250 - 499	33	52%
500 - 749	20	32%
750 - 999	3	5%
1,000 - 1,999	4	6%
2,000 - 2,999	1	2%
3,000 +	1	2%
Average fee	€591	-
Maximum fee	€3,442	-
Source : www.greyhounds.com.au		

On the assumption that the greyhound industry in Australia is not dissimilar to that in Ireland, the information shown in Table 3 above appears to support a general conclusion that that high stud fees are available in respect of small numbers of dogs only and that the majority of stud fees fall into the lower end of the scale of fees.

This conclusion would appear to be further supported with reference to an internet-based listing of Irish male greyhounds for sale, an examination of which revealed the figures shown in Table 4 below.

Table 4 – Irish male greyhounds for sale - July 2005		
€ Sale price range	**Number of dogs**	**% of total**
1-2,499	30	48%
2,500-4,999	18	29%
5,000-7,499	4	6%
7,500-10,000	3	5%
10,000-12,499	2	3%
12,500-14,999	2	3%
15,000-17,499	1	2%
17,500+	2	3%
Average sale price	€4,089	-
Maximum sale price	€25,000	-
Source : www.greyhounds.ie		

Table 2 showed that the top ten stud dogs sire 185 litters per annum. If it is to be assumed that the sale price of a male dog includes some provision for the value of its future stud fees then it can be seen from Table 4 above that the anticipated level of future stud fees, even for the most expensive dogs listed for sale in July 2005 are not significant. It is of course also possible to conclude that the highest stud earners are unlikely to be listed for sale having regard to their potential fee income.

4. Calculating the Exchequer Cost of the Tax Relief

The Tax Liability of Persons involved in the Greyhound Breeding sector

Greyhound breeding is an activity principally carried out by the farming community. Anecdotal evidence suggests that the traditional approach to greyhound breeding and racing has not altered significantly in recent years. The main changes have been a greater degree of popularisation as a result of the promotional activities of Bord na gCon and increased Government funding to greyhound racing through the provision of stadia improvements and increased prize money. However, even allowing for this increased popularisation, prize money remains low and the value of racing and breeding animals also remains low in comparison to the position in the horsebreeding sector.

Based on an analysis of the tax take from farming profits and from the farming sector over recent years, it would appear that the potential cost to the Exchequer in terms of tax forgone as a consequence of this tax relief is relatively low. However, having regard to the information shown in Tables 1 and 2 above, it is possible using certain assumptions to arrive at estimates of the potential loss to the Exchequer under different scenarios.

The potential cost to the Exchequer

Rather than use the approach of estimating an average cost to the Exchequer over the lifetime of the exemption it is felt that an estimation of the costs for the most recent year (2003) for which details on matings and stud fees are available is the most appropriate action. The main reason for adopting this approach is that an analysis of the existing data leads to the conclusion that in the past number of years there has been a concentration of mating activity in a small number of top dogs with the top 10 dogs accounting for approximately 40 per cent of total matings. Thus while the number of matings since 1996 has not increased to any significant extent, the average covering cost has increased during this period due to the increased utilisation by breeders of the services of the more expensive top sires.

Calculation of Tax Forgone

The calculation of the amount of tax forgone in respect of this exemption can only be based on the data currently available which was derived from an analysis of the Greyhound Stud Book and information received from the industry. There are significant gaps in this data especially in relation to the costs incurred by greyhound breeding undertakings and estimates of these costs are based to significant extent on certain assumptions.

Table 1 shows that the number of matings in 2003 was 5,870. In order to estimate the amount of covering fees for the year 2003 taking into account the fact that approximately 40% (1,850) matings were accounted for by the top ten greyhound studs it is felt that the calculation of stud fee income should be split into two tranches, the first for the top ten dogs and the second for the remaining dogs.

The top ten studs account for an estimated €3.45m stud fee income, based on an average stud fee of €1,500 (see table 2) and a total of 2,300 matings. While industry sources did not supply figures for the numbers of matings from the top ten studs they did advise this Department that each of the top 10 studs accounts for an average of 185 litters per annum, giving an aggregate litter total of 1,850 for these dogs. This 1,850 total is increased by 25% to allow for a differential of about 25% between the lower number of litters registered in comparison to the number of matings, to give an annual total of 2,300 matings at a fee of €1,500 per cover.

It is estimated that the stud fees for the remaining stud dogs, which account for 3,570 of the 2003 matings, is €1,750,000 based on a covering fee of €500 per mating (see table 2). This gives an overall estimate of €5,235,000.

The cost figures in terms of tax forgone outlined above are gross figures and are indicative of the cost of this relief before losses and necessary costs associated with the keeping of greyhound studs are taken into account. As things stand such losses and costs cannot be taken into account when assessing tax liability. They are in effect ring-fenced against taxable income. If the exemption were removed, these losses and costs would then be allowed both against the trade of greyhound breeding and other income. For example the purchase cost of a stud greyhound for breeding purposes is not allowable as a deduction against tax at present nor are the costs associated with the upkeep of the animal and veterinary care. There are currently no Revenue data available on such losses, however allowing for the high turnover of breeding stock, advertising fees, veterinary and upkeep expenses and wage costs for 30 full-time employees, the estimated allowable costs against tax would be of the order of €2 million. Allowing for these losses would give a net income from fees total for 2003 of €3.235m.

It appears to be widely accepted that historically, greyhound breeding was an activity principally associated with the farming community. Anecdotal evidence suggests that the traditional approach to greyhound breeding and racing has not altered significantly in recent years. Information on the taxation of farmers compiled by the Revenue Commissioners show that there were an estimated 37,300 farmers (or 37.75%) liable to pay tax on farm profits. These figures exclude 10,600 "trader" farmers of whom an estimated 5,700 were liable to tax as it is not possible to distinguish the number of these who pay tax on farm profits only. The gross income of those full-time farmers assessable to tax was €1,625 million. However, a percentage of this income (c.39% in 2002) is liable to taxation as PAYE income. Applying this percentage to the gross income of those full time farmers liable to tax (i.e. €1,625 million) gives the gross income from farming as €991 million. As the total yield from farmers in respect of income tax on farming profits for 2002 was €126.2 million this gives an average tax rate for farmers of c.13%. Applying this 13% rate to the €3,235,000 in estimated stud fees for 2003 gives an estimated gross tax forgone of **€420,550 p.a.**

One final issue which cannot be ignored concerns the question as to whether, and to what extent, the income from greyhound breeding would have been declared if the tax exemption were not in place. Greyhound breeding to some extent represents a pastime or hobby rather than a serious commercial undertaking. In such an environment it is possible that a significant level of income from breeding in the absence of the exemption might not be openly or fully declared. The estimated tax costs set out above may therefore represent a maximum level of the tax revenues theoretically available to the Exchequer in the absence of the tax relief.

4. EU State Aid Issues

As noted earlier, the tax relief for greyhound stud fee income was introduced in 1996 to bring the tax treatment of greyhound breeding into line with the long-established tax relief for the horsebreeding sector.

However, the stallion stud fee exemption has been the subject of correspondence between the Department of Finance and the European Commission since 2004, in relation to the compatibility of that tax scheme with EU State Aid rules. Given the close parallels between the tax reliefs for stallion stud fees and greyhound stud fees, it would be appropriate that any decisions taken in relation to the former, whether in the context of the EU State Aid issues or otherwise, should apply likewise to the latter.

5. Conclusions

The following general conclusions can be drawn from the analysis set out above:-

- It is not possible to determine with accuracy the Exchequer cost of the tax relief for greyhound stud fee income. Any estimate of cost must be somewhat tentative as it would have to be based on qualitative estimates and assumptions.
- The introduction of the greyhound stud fee exemption has had no significant influence on the average annual number of services by stud greyhounds.
- Since the introduction of this exemption the actual number of stud greyhounds has declined but the number of matings by the top studs has increased markedly. There has been a concentration of stud activity among a smaller number of higher class animals.
- Notwithstanding the increased popularity of greyhound racing in recent years any increased profits accruing to the owners of stud dogs since the inception of the tax relief have accrued to a small number of owners only.
- Based on the estimates and assumptions used, the total cost to the Exchequer arising from the introduction of the tax exemption is unlikely to have exceeded €0.4 million p.a. Having regard to the levels of tax liability of those persons traditionally involved in greyhound breeding, and to the non-commercial, hobby-type nature of the activity for a significant proportion of participants, the actual net cost to the Exchequer may indeed have been significantly less.
- The future of the tax relief for greyhound stud fee income should be considered together with the future of the closely similar tax relief for stallion stud fee income, having regard to the State Aid and other considerations that arise in that context.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section G:

Tax Relief for Pensions Provision – Sections 770-790B of the Taxes Consolidation Act 1997

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Executive Summary

I. Conclusions and Options

I.I The Review's conclusions are set out in ***Section 15*** and can be summarised as follows:

- Current tax reliefs appear to be very generous in relation to individuals whose employers are in a position to make substantial tax deductible contributions to their schemes effectively without limit, particularly in circumstances where they can influence the level of employer contributions and their remuneration level.

- The current regime may be perceived to be inequitable in so far as more generous reliefs are available to those in occupational pension schemes as compared with those availing of RACs (Retirement Annuity Contracts) or relying on PRSAs (Personal Retirement Savings Accounts).

- The "maximum benefits" rule of a pension of two thirds final remuneration appears to be ineffective in the absence of an absolute cap on the "salary" to which the 2/3rds rule is applied.

- The "3 year average" rule for determining final remuneration may allow an increase in earnings in the run-up to retirement to maximise the final remuneration figure on which maximum benefits are calculated.

- A tax-free lump sum of 25% of the value of the accumulated pension fund may be too generous when the value of the fund is substantial.

- The ARF option
    - has, to date, largely not been used to fund an income stream in retirement;
    - may be encouraging the build-up of very substantial pension funds with a view to availing of the long-term tax exempt environment of the ARF where there are no distributions from the ARF; and
    - may be undermining the "EET"[184] system of pension taxation in that an individual with sufficient independent means can benefit from
        - exempt contributions to a pension fund,
        - exempt or "gross roll-up" in respect of the income and gains of the fund,
        - a tax-free lump sum of 25% of the value of the pension fund,
        - exempt transfer to, and further roll-up in, an ARF (in place of a taxable pension), and
        - limited, if any, taxation on transfer on death.

[184] "EET" means exempt contributions to the pension fund, exempt growth in the fund and taxed pension payments.

I.II *Section 16* sets out a number of options for change and the perceived pros and cons applying to each are outlined. The options are aimed primarily at proprietary directors and senior executive staff who may be in a position to tailor their remuneration structure and the level of their employer's contributions so as to avail of maximum benefits under the current regime. The options are-

Option	*Description*
1	Include employer contributions to occupational pension schemes within the age-related % limits and annual earnings cap of €254,000 applying to employee contributions.
2	Place an absolute cap on the size of the maximum tax-relieved retirement fund.
3	Place an absolute cap on the tax-free lump sum of 25% of fund value that can be taken from an occupational pension scheme.
4	Cap the maximum final salary on which a pension can be based.
5	Extend the averaging period over which final remuneration is calculated from 3 or more consecutive years ending not earlier than 10 years before the relevant date, i.e. the date of retirement, to say 10 or more consecutive years.
6	Introduce an annual flat rate tax charge on the value of an ARF fund or on the undistributed income and gains of an ARF fund.
7	Deem a notional annual distribution to be made from an ARF on the basis of a set return of say 3% per year on the value of the ARF. The notional distribution to be taxed at the ARF owner's marginal rate of tax.
8	Treat transfers from an ARF to an adult child on the death of the ARF holder as income of the deceased in the year of death.
9	Place an upper limit on the amount of employer contributions to a pension fund that can be placed "tax-free" in an ARF - effectively requiring employer contributions above the limit to be taken at retirement as a taxable lump sum or used to purchase an annuity.

I. INTRODUCTION

1. Background

1.1 In his 2005 Budget Statement the Minister for Finance announced a review of tax expenditures and exemptions by the Department of Finance and the Revenue Commissioners. The purpose of the review is to bring forward proposals to ensure that the right balance ensues from such reliefs as between the benefits to the investors and the good of the community. Underpinning the review is the Minister's overall aim to seek to improve the overall equity of the tax system.

1.2 Apart from the main property-based reliefs a range of other reliefs and exemptions require examination, including, with particular reference to the potential impact on high earners, relief for pension provision. In relation to this aspect of the review, Revenue expressed caution as to its ability to obtain meaningful data on the use of pension reliefs by high-earners to substantially reduce their tax liability.

2. Context

2.1 There has been much public and political comment on the use of pension tax relief by high earners. Much of this comment has focussed on the apparent ability of companies to make sizeable tax-exempt payments into the pension funds of their directors who could subsequently avail of changes made to the pensions regime since 1999 to place the funds into Approved Retirement Funds (ARFs). The ARF fund could then pass tax-free to a surviving spouse or pass to the next generation in a tax-efficient manner.

2.2 Apart from the particular focus on ARFs and their use by high earners, the pension system generally has also been the subject of a number of reports and publications in the first part of 2005 (see bibliography at Appendix 1). A common theme running through many of these papers on tax costs is that the favourable tax arrangements for private pension provision predominantly favours higher income taxpayers.

3. Review Approach

3.1 The concerns surrounding the use of pension tax reliefs by high earners tend to focus on -

- the generous pension funding rules that can be availed of by proprietory directors, and

- the use of ARFs as a vehicle for

  i) sheltering assets from taxation, and

  ii) the tax-efficient intra-generational transfer of assets.

Accordingly, this review concentrates on -

- examining the tax arrangements for pensions to see if they are being used by high net worth individuals in unintended ways having regard to the significant changes introduced in 1999,

- looking at the rules to see if they are actually delivering on the original policy objectives - in other words, do the current rules allow for more generous treatment than is required having regard to the purpose of tax relief for pensions, namely, the provision of pension benefits for individuals and their widows/widowers on retirement,

- considering whether it is the case that the current ARF rules are encouraging some individuals to take advantage of other aspects of the pension tax regime in order to maximise the value of an ARF fund as opposed to taking a pension payment, e.g. possible exploitation of the funding rules so as to allow proprietary directors to extract funds from a company in a tax efficient manner, to permit the accumulation of assets in a tax free environment and/or the intra-generational transfer of assets in a tax efficient manner.

3.2 To this end, the following paragraphs -

- set out the rationale for and the rules governing tax relief for pension provision generally;
- set out the legislative rules and relevant administrative practices governing the operation of small self administered pension schemes (SSASs);
- examine the legislation and rules governing the operation of ARFs and their purpose;
- set out the findings arising from an analysis of available information on the pension arrangements of certain high earners;
- set out the findings of an examination of ARF schemes as respects numbers, amount of funds invested, and the extent to which funds are being drawn down for pension purposes;
- set out conclusions and suggest possible options for change.

II. PENSIONS – CURRENT STRUCTURE AND RULES

4. Pension Provision

4.1 There are two main components to the pension system in Ireland. The "First Pillar" State social welfare system comprises contributory pension benefits for those who satisfy the PRSI contribution conditions and non-contributory pension benefits, which are subject to a means test, for those who do not qualify for contributory benefits[185]. The "Second Pillar" system comprises three main types of private pension arrangement – public service "pay as you go" schemes, funded occupational pension schemes and personal pension arrangements. These private arrangements are voluntary in the sense that there is no legal obligation on employers[186] to provide pension benefits for their employees or for individuals to effect any form of pension arrangements for themselves.

4.2 The State encourages individuals to supplement the State pension with private pension arrangements by offering generous tax reliefs on private pension provision. The tax relief arrangements for private pension provision are long-standing and have helped a significant proportion of the workforce to provide for supplementary pensions thus reducing the pressure on the Exchequer to fund pension needs. Just over half of those in employment are covered by voluntary private pensions[187]. In summary, tax relief takes the form of relief on amounts contributed to the pension schemes and on the amount of profits and gains generated by the investments held by the schemes. Benefits payable on retirement are taxable subject to an entitlement to take a tax-free lump-sum cash benefit.

4.3 This system is known as the "EET" system of pension taxation, i.e. exempt contribution, exempt fund growth and taxable benefits. Essentially, contributions to pension investments are tax relieved on the way in and are allowed to grow tax free in the pension fund in the expectation that the pension benefit stream will be taxed on the way out. Fourteen out of the fifteen "old" EU member States operate the EET system and it is the preferred system from the point of view of the EU Commission.

4.4 The private pension system (excluding the public sector pay-as-you-go schemes) comprises occupational pension schemes and personal pension arrangements. The occupational schemes are provided on a voluntary basis by

[185] A retirement pension can be claimed at age 65 if the person is retired from full time employment and satisfies certain social insurance contribution conditions. The old age contributory pension can be claimed at age 66 or over, once certain social insurance contribution conditions are satisfied – the recipient can continue to work full time. The old age non-contributory pension is a means-tested payment for people aged 66 or over who do not qualify for retirement pension or old age contributory pension based on their social insurance record.

[186] Apart from the legal requirement on an employer to offer a PRSA to his/her employees – although there is no obligation on the employer to contribute.

[187] According to CSO Quarterly National Household Survey Q1 2004, pension coverage rate for all persons in employment aged between 20 and 69 in first quarter of 2004 was 52.5%. This includes public and private sectors; employed and self-employed. National Pension Policy Initiative target is a coverage rate of 70% for those aged 30 to 65 – rate currently stands at 59.1%..

employers for their employees and are funded either jointly by employers and employees or by the employer alone. In the past the most common form of occupational pension scheme was a *defined benefit scheme*. Under this type of scheme the pension and other benefits to be paid to members and/or their dependants are specified in the scheme rules and are generally linked to final salary. The aim of such schemes is to provide an earnings-related addition to the social welfare pension so as to enable scheme members to maintain in retirement a standard of living linked to their pre-retirement situation. Under the rules of defined benefit schemes, the employer is responsible for making up any shortfall in the pension fund due to poor investment performance. Currently, the most common type of occupational scheme is the *defined contribution scheme*. Under these schemes the individual member's benefit is determined solely by reference to the contributions paid into the scheme and the investment return earned on those contributions. A specified proportion of earnings is contributed to the fund (by the employer and employee or employer alone) and the value of the pension annuity at the end of the day depends on fund performance and interest rates at the time the pension annuity is purchased. In these schemes, in contrast to defined benefit type schemes, the scheme member takes the risk of poor investment performance by the fund. Statutory rules restrict the maximum benefits payable, under both defined benefit and defined contribution schemes, to two thirds of pre-retirement earnings taking into account any benefits paid as lump sums.

4.5 Personal pension arrangements consist essentially of Retirement Annuity Contracts used by the self-employed and more recently Personal Retirement Savings Accounts (PRSAs). These contracts and accounts operate like defined contribution schemes in that the risk of underperformance lies solely with the individual taking out the contract or account.

4.6 For the purposes of this review, the focus is primarily on occupational pension schemes, with particular emphasis on small single person schemes used by proprietary directors and top executives (i.e. Small Self-Administered Schemes and single member schemes structured as a life assurance pension policy) and for comparative purposes, on personal pension arrangements (i.e. RACs and PRSAs).

5. Tax Relief for Pension Provision

5.1 The overall cost of income tax relief for pension contributions is tentatively estimated at €1.1 billion for the 2001 "short" tax year (estimated at €1.4 billion as adjusted for 2001 full-year equivalent). The cost has climbed steadily in recent years as indicated in the table following. The costs associated with the exemption from income and gains arising on pension funds themselves would be additional.

Estimated Cost of Income Tax relief relating to pension contributions*

	1997/98	1998/99	1999/00	2000/01	2001 "Short" Year	2001 Full Year
Contributions by employers **	€435.5m	€533.4m	€595.4m	€646.2m	€497.7m	€660m
Contributions by employees**	€256.5m	€328.9m	€420.5m	€471.9m	€388.7m	€515m
'Retirement Annuity Contracts'***	€91.3m	€116.2m	€180.8m	€205m	€170m	€225m
Estimated Total	***€783.3m***	***€978.5m***	***€1196.7m***	***€1319.1m***	***€1056.4m***	***€1,400m***

* Source - Revenue
** These are extremely tentative estimates
*** Available to the self-employed and to employees not in occupational pension schemes.

It is not possible to provide an estimate in respect of employee and employer contributions to occupational pensions because the relevant data in relation to contributions is not captured in such a way as to provide a dedicated basis for compiling this information. Tax relief for pension contributions by employees is normally given by way of a deduction from total income in arriving at income for tax purposes i.e. the income for tax purposes of employees is net of their pension contributions (the 'net pay' arrangement). The employer's contributions are an allowable deduction from profits and are not specifically recorded in Revenue statistics.

Provisions were included in Finance Act 2004 requiring employers to provide data on superannuation contributions in the P35 form to be filed by employers in February 2006. Preliminary information should become available in mid-2006, bearing in mind Revenue have to carry out a programme to check the quality, consistency and accuracy of the returns. These changes will yield additional information regarding the overall cost of tax relief for pension contributions but as the returns will be aggregated at employer level they will not provide a precise basis for measuring the potential impact on the Exchequer of proposals for changes at individual level.

5.2 The principal features of current tax relief arrangements and controls are as follows:

Occupational Pension Schemes

- Contributions made by employees are deductible for income tax and PRSI purposes and are tax relieved at the individual's marginal income tax rate. Age related % limits apply to contributions as follows:

Age	*Limit as % of Remuneration*
Under 30	15%
30-39	20%
40-49	25%
50 -70	30%

In addition, tax relievable contributions are subject to an earnings cap of €254,000[188] per annum with the result that the maximum annual tax relieved employee contribution is limited to €76,200 i.e. €254,000 x 30% for an employee aged over 50.

- Contributions by employers on behalf of employees are tax deductible in computing the profits for tax purposes of the employing business. However, arguably the most significant tax relief in relation to employer contributions is that they are specifically exempted (s.118(5) TCA 1997) from being charged as remuneration of the employees concerned, in the form of benefits-in-kind. One result of this tax exempt treatment of these benefits to employees is that the age and earnings-related restrictions on tax relief for pension contributions, mentioned above, are by-passed: the age-related percentages and earnings cap do not apply at all to restrict the tax exemption of employers' contributions. The "control" in this regard is the statutory rule which limits the tax relieved pension fund that can be created by contributions to a fund capable of providing a pension of two-thirds of final remuneration. In practice this control may not be very restrictive.

- The investment income and capital gains of a scheme are exempt from income tax and capital gains tax

Personal Pension Arrangements:

Retirement Annuity Contracts

These relate primarily to insurance policies effected by an individual with an insurance company. All contributions are paid by the individuals themselves. The sole "control" on contributions to Retirement Annuity Contracts is by reference to the statutory limits on tax relief for contributions. While contributions in excess of the limit may be made they will not qualify for tax relief but can be carried forward for relief in subsequent years.

- As with occupational pension schemes, contributions are deductible for income tax and PRSI purposes and are tax relieved at the person's marginal income tax rate. The same age-related % limits[189] apply to tax-relieved contributions as outlined above in relation to occupational schemes.

[188] The €254,000 earnings cap is a single cap that applies across all pension contributions in respect of an individual including occupational pension schemes, AVCs, personal pensions, and PRSAs (both employer and employee).

[189] The 30% limit applies, irrespective of age, to certain categories of professional sportspersons.

- Tax-relieved contributions are also, in addition to the % limits, subject to an annual net relevant earnings[190] cap of €254,000. However, a contribution not allowed in one year may be carried forward and relief allowed in subsequent years subject to the annual limit.

- The investment income and capital gains of investments used to back personal pensions are exempt from income tax and capital gains tax.

- Unlike occupational pension schemes where there is a limit of two-thirds of final remuneration no benefit limits apply.

Personal Retirement Savings Accounts

Personal Retirement Savings Accounts (PRSAs) are a relatively new type of pension vehicle introduced in 2002 as a flexible low-cost portable pension product which can be used for long-term retirement provision by everyone – employees, self-employed or unemployed. In effect, it is a contract between an individual and a PRSA provider (insurer, credit institution or investment firm) in the form of an account that holds units in investment funds managed by PRSA Providers. They are mainly designed to act as a vehicle for retirement savings for those who are not members of occupational pension schemes. The tax treatment of PRSAs is similar to that given to personal pensions.

- Contributions are deductible for income tax and PRSI purposes and are tax relieved at the person's marginal income tax rate. Age related % limits apply to contributions as per those outlined above in relation to occupational schemes and personal pensions.

- Tax-relieved contributions are subject to an annual earnings cap of €254,000.

- Employers may also contribute but, unlike the position for occupational pension schemes, such contributions *are* treated as benefits-in-kind and included within the age-related % limits and within the overall €254,000 earnings cap, for the purposes of tax relief. Employer contributions which, together with employee contributions, exceed these limits would result in an unrelieved BIK charge on the employee in respect of that excess.

- The investment income and capital gains of a PRSA are exempt from income tax and capital gains tax.

- As with Retirement Annuity Contracts, no benefit limits apply.

5.3 From the foregoing description of the main rules and tax reliefs available for various pension products, it is clear that anomalies in the tax treatment remain. This is notwithstanding that changes made in recent years were intended to standardise tax

[190] Net relevant earnings consist essentially of income less deductions which would be made in computing total income for tax purposes, including losses and capital allowances.

relief across the various pension products. For example, the current age-related percentage limits of 15 to 30% of remuneration/net relevant earnings and the earnings cap of €254,000 applying to contributions, were first introduced in relation to Retirement Annuity Contracts in the 1999 Budget. The same limits were applied to PRSAs when they were introduced in 2002 and to employee contributions to occupational schemes in Finance Act 2002 also. However, unlike the position in relation to PRSAs, the age-related % limits and the earnings cap do not apply in relation to employer contributions to occupational pension schemes on behalf of an employee. The narrower scope of the age-related % limits and earnings cap in the case of occupational pension schemes compared with PRSAs, is essentially the result of the exemption from a BIK charge of employer contributions to the former but not to the latter. The limits and cap apply to all contributions to RACs as employer contributions are not a feature of such contracts. Therefore, whilst there is a clear limit on tax-relieved contributions to RACs and PRSAs, that limit does not operate in relation to occupational pension schemes. The "control" in this regard is the statutory maximum benefit of two-thirds final remuneration that can be funded. For the majority of employees the maximum benefit rule is not an issue as the level of pension funding in defined contribution schemes is unlikely to be sufficient to provide a benefit of 2/3rds final salary. The evidence and analysis later in this review suggests, however, that where the only "limit" applying is the size of the fund required to provide maximum benefits, then in the absence of an absolute monetary cap on

- the salary figure on which the 2/3rds maximum is based, or
- the fund which is to deliver that maximum pension benefit,

it may be defective as a control tool in relation to certain categories of "employees".

5.4 In this regard, it should be noted that the question of standardising tax reliefs across different forms of Defined Contribution schemes with a view to simplification and overcoming some of the barriers to increasing pension coverage has already been the subject of review by a Round Table Working Group[191] established by the Pensions Board in 2003. The aim was, among other things, to establish a level playing field for all Defined Contribution pension provision (i.e. for occupational pension schemes, RACs and PRSAs) in terms of contribution levels eligible for tax relief, tax free lump sums and conditions for taking benefits. The proposals arising from the review included:-

- standardising maximum total *employee and employer* contributions for occupational schemes at the same age related % of earnings figures as for RACs and PRSAs;
- extending the €254,000 income cap to *employee and employer* contributions to Defined Contribution occupational pension schemes; and
- applying a 25% limit to all tax free lump sums.

[191] This group was established in June 2003 by the Policy Committee of the Pensions Board to progress the more straightforward recommendations raised in the original Pensions Board Simplification Report of 2002. The Group comprised representatives of the Pensions Board , Department of Finance, Department of Social & Family Affairs and Revenue.

The proposals envisage the changes applying to

- members of new Defined Contribution occupational schemes;
- new members of existing Defined Contribution schemes; and
- existing members of existing Defined Contribution schemes born after 1954, (giving such individuals a reasonably long lead in period to adjust their plans).

While the principal benefit from the proposed changes is seen as eliminating the main differences between Defined Contribution product types, thus reducing the need for complex and expensive advice, there would clearly be benefits arising too, from the extension of the age related % limits and the annual cap to combined employee and employer contributions to occupational pension schemes. However, there were no proposals in relation to defined benefit schemes.

6. Small Self-administered Pension Schemes

6.1 Small self-administered pensions schemes (SSASs) are a particular type of occupational pension scheme in respect of which special Revenue requirements apply in relation to their approval, operation and supervision. In summary, Revenue consider a scheme to be an SSAS where

- it has less than 12 members, or
- where 65% or more of the value of the investments of the scheme can be shown to relate to the provision of benefits to 20% directors (or their respective spouses and dependants).

The reason for the extra rules is to ensure that such schemes are in fact "bona fide" established for the purposes of providing retirement benefits and not for tax avoidance purposes. The concern in this regard relates to the fact that, as SSASs are typically single member schemes – that member being a proprietary director - there is clear potential for a conflict of interest. The individual involved is normally the owner of the business, a trustee of the scheme (along with the pensioneer trustee required by Revenue rules – see following) and the scheme member.

6.2 The principal restrictions placed on SSASs by Revenue, under their discretionary powers to approve retirement benefit schemes, are

- the requirement to appoint a "pensioneer trustee" (a professional trustee, person or body widely involved in occupational schemes) as a scheme trustee, to act in a "watchdog" capacity and primarily to ensure that a scheme can only be wound up in accordance with the rules of the scheme;
- limitations on investment options primarily relating to a prohibition on loans to scheme members, self-investment and investment in pride in possession articles and restrictions on property investment (e.g. the vendor must be totally at arm's length, no investment in holiday homes); and
- regular reporting requirements (e.g. submission of annual accounts and regular actuarial reports).

While Revenue rules also require SSASs to be capable of providing for a pension by way of the purchase of an annuity from a Life Office (rather than directly from the fund itself), the benefit option taken by most SSAS members is to transfer the value of the fund to an Approved Retirement Fund rather than traditional annuity purchase – (see paragraph 11.2).

6.3 The number of SSAS schemes notified to the Pensions Board as at 2004 was approximately 2,500 – see table following. The vast bulk of these have been formed since 1999 – the year in which the ARF option was created. There was a noticeable increase in the number created between 2003 and 2004 - more than doubling to 930 new schemes. While there is no evidence to make a causative link, this increase coincided with the relaxation of the borrowing rules for occupational pension schemes. There may be other reasons why SSASs are becoming more attractive to high net worth proprietary directors. For example, SSASs offer direct control of investment policy and transparency of charges compared with Life Company insured arrangements and the freedom to invest with a wide spread of different fund and investment managers rather than being locked into one Life Company range of unit funds etc.

SSAS creation 1990 to 2004

Year	**No. Schemes Commenced**	**No. of schemes still current to date**
1990 - 1996	115	90
1997	38	35
1998	130	107
1999	186	156
2000	343	303
2001	329	310
2002	249	234
2003	407	400
2004	930	923
Total		**2,558**

7. Current Rules for Funding Pension Benefits

7.1 As outlined in paragraph 5.2, as a general rule tax relief is given on all contributions paid to a pension scheme subject to an overall annual limit depending on age in respect of employee contributions, but with no upper absolute level on the amount on which relief can be claimed for employer contributions in respect of occupational pension schemes. The way in which the legislation limits the Exchequer's exposure in this regard is to limit the amount of "benefit" that can be funded for.

7.2 Under current rules (see details at Appendix 2)[192], the maximum pension that an individual can receive at normal retirement age is two-thirds of final remuneration. The rules envisage this accruing over a period of 40 years' service with the same employer at the rate of 1/60th of final remuneration for each year of service – this is known as "the strict 1/60th basis". However, it is possible to qualify for this maximum benefit over a shorter period under what is known as the "uplifted scale". Under this approach an individual can, starting not less than 10 years from normal retirement age, fund for the maximum benefit of two-thirds of final remuneration.

7.3 Part of the maximum pension benefit can also be commuted into a tax-free lump sum. The maximum lump-sum benefit that can be achieved at normal retirement age by an employee is one and a half times final remuneration i.e. 3/80ths of final remuneration for each year of service over 40 years. Late entrants can commute part of their pension at a higher rate than this but, in that regard, the maximum lump sum commutation of one and a half times final remuneration can only be provided where the employee has 20 years' service with his or her current employer.

7.4 A consequence of the maximum benefit level is that the amount of funding for those benefits by means of tax-relieved payments is not unlimited. In theory, indirect control is exercised, on the amount of tax relief afforded, by the Revenue rules requiring that the amounts contributed by the employer be reasonable and that scheme assets should not amount to more than what is required to provide the benefits which the scheme has a commitment to pay.

7.5 In reality, as practically all occupational pension schemes set up in the last 15 years have been defined contribution schemes[193] with no specific "benefit promise" in terms of a guaranteed level of pension, pension benefits are unlikely to come any where near the two-thirds maximum of final remuneration for the vast majority of scheme members. The exception, in this regard, relates to certain categories of employees, i.e. proprietary directors and top executives. These employees are able to negotiate their level of "final remuneration". Given that ability to adjust the remuneration component of the limit, the two-thirds rule, in the absence of an absolute limit, is ineffective and never likely to be breached.

8. Calculation of Final Remuneration

8.1 Revenue administrative rules permit a number of methodologies to be used for calculating final remuneration for the purposes of determining benefits under occupational pension schemes. The most commonly used method in relation to proprietary directors and top executives is the three-year average rule. This rule is based on the average of the total emoluments for any 3 or more consecutive years ending not earlier than 10 years before the relevant date, i.e. the date of retirement. In practice, this rule may allow those (referred to in the preceding section) who can negotiate their salary in the period immediately prior to retirement (and employer contributions to their pension funds) to maximise their pension benefits.

[192] These rules derive from the statutory discretion given to Revenue to approve schemes that do not meet the prescribed statutory conditions, subject to broad parameters set out in the legislation – section 772(4) TCA 1997 refers.

[193] Most DB (Defined Benefit) schemes are now closed to new members with DC (Defined Contribution) schemes being set up for them.

9 Funding Rates

9.1 The level at which funds should flow into a pension scheme to meet the benefit promise are actuarially determined having regard to Revenue requirements and accounting and actuarial regulations and guidelines. Calculations must take account of variables such as age at commencement, life expectancy, future rates of pay, future investment returns etc. With pension benefits valued by reference to current annuity rates, which in turn are linked to historically low interest rates, the net effect is that the cost of purchasing €1 of pension is twice what it was 15 years ago.

9.2 There are issues relating to the manner in which pension benefits are valued and funding rates determined. Revenue are currently in discussion with the Society of Actuaries in Ireland to ascertain if it is possible to agree maximum contribution rates which would be used in respect of all multi-member Defined Contribution schemes and single member schemes. The issues are illustrated in the following table provided by the Society.

9.3 The table shows the variations of Revenue maximum contribution rates, based on a retirement age of 65, that are used by a sample of four different life offices and the potential maximum rate that could be used if *all* the elements of current practice, that lead to higher scope, were used together. Clearly, greater consistency is required.

Revenue maximum contribution rates

Age	Office A	Office B	Office C	Office D	Potential
30	31%	76%	45%	63%	236%
35	38%	84%	56%	74%	244%
40	47%	95%	72%	89%	250%
45	63%	111%	95%	112%	266%
50	89%	137%	135%	148%	300%
55	148%	188%	215%	216%	380%

9.4 The figures show that a proprietary director age 55 with no previous pension arrangements could set up an occupational pension scheme for himself that actuarially at commencement would not exceed the maximum pension requirement of two thirds final remuneration, by having the company contribute annually between 148% and 216% of his annual remuneration depending on which of the four life offices he approached. As a proprietary director he could, at retirement (and subject to a maximum benefits test) then take 25% of the fund tax-free and place the rest tax-free into an Approved Retirement Fund. The final column in the table shows that if all of the maximum assumptions used by the 4 Life Offices were used together the potential funding level could be as high as 380% of annual remuneration yet still theoretically stay within the two thirds maximum allowable benefit provided for by the legislation.

III. APPROVED RETIREMENT FUND REGIME – RULES AND USE OF ARFS

10. Approved Retirement Funds/Approved Minimum Retirement Funds

10.1 Approved Retirement Funds (ARFs) were introduced by the Finance Act 1999 and represented a significant change in the structure of pension arrangements. The ideas underlying the changes were choice, control and flexibility. Whereas up to that time pensioners were effectively forced to take out an annuity at retirement which in many cases "died" with them, as a result of the 1999 (and subsequent) changes, certain pensioners can now choose between -

- investing in an ARF and/or an Approved Minimum Retirement Fund (AMRF),
- purchasing an annuity, or
- taking the value of their pension fund at retirement, subject to tax.

10.2 ARFs and AMRFs are not pension schemes per se, but investment options into which the proceeds of certain pension arrangements can be invested on retirement. Individuals are entitled to take their tax-free lump sum[194] option as part of the election for an ARF. Beneficial ownership of the assets in an ARF/AMRF vest in the individual. The ARF/AMRF is managed by a Qualifying Fund Manager and pays no tax[195] on its investment income or capital gains while the funds are invested in it. Sums withdrawn from the fund are subject to tax at the individual's marginal rate, other than when they are transferred to another ARF which is also beneficially owned by that individual.

10.3 Special tax rules apply in relation to transfers or withdrawals on the death of the ARF/AMRF owner. While, as a general rule, such transfers or withdrawals are treated as the income of the deceased in the year of death and subject to tax at his or her marginal rate, this general obligation is removed where the transfer is to an ARF of the deceased's spouse or to his or her children. The table overleaf summarises the position.

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[194] In the case of a personal pension policy holder or an ordinary PRSA contributor the tax free lump sum amounts to 25% of the value of the policy or contract. A proprietary director can opt for the standard 150% of final remuneration under an occupational pension scheme where he/she is purchasing an annuity or 25% of the value of the occupational pension scheme fund where the ARF option is taken. A Proprietary Director (i.e. 5% director) is defined in s770(1) TCA and basically means a director who, within 3 years of retirement or leaving service, held more than 5% of the voting shares in the employer or its parent company. Shares held by a spouse and minor children are counted, as are shares held by a trust to which the director concerned had transferred shares.

[195] ARFs as originally created contained a complex system of taxation involving taxing the ARF holder on the profits and gains earned by the ARF as they arose, irrespective of whether they were drawn down or not, with withdrawals then being allowed tax-free. Finance Act 2000 changed these arrangements so that now ARFs/AMRFs are treated for tax purposes in the same manner as pension funds.

Tax Treatment of Transfers from ARF on Death

	Transfers on Death of ARF Holder		***Transfers on Death of Spouse***	
	Income Tax	***CAT***	***Income Tax***	***CAT***
Spouse	None*	None		
Child under 21	None	Yes**	No	Yes**
Child over 21	Yes @ 20%***	No	Yes @ 20%***	No
Others	Yes @ Marg. Rate of ARF Holder	Yes****	Yes @ Marg. Rate of ARF Holder	Yes****

*Spouse is charged to tax at marginal rate in normal way on any future withdrawals from ARF
** Child will benefit from CAT tax free thresholds.
*** As the amount charged to tax is not treated as income for any purposes of the Income Tax Acts, other than the 20% charge, the child cannot seek to reduce the charge by the use of allowances and reliefs.
**** Individuals will benefit from appropriate CAT tax-free thresholds.

11. Who can avail of the ARF option?

11.1 The option to have all or part of an individual's accumulated pension fund placed in an ARF must be exercised "on or before" the date on which the annuity or pension would otherwise become payable. The option is open to a qualified person who is either over 75 years of age or who has a guaranteed pension income (specified income) for life of €12,700 per annum at least. In this regard, the pension must actually be in payment – pensions anticipated at some time in the future cannot be brought into the reckoning. Where the minimum specified income test is not met, then an AMRF may[196] have to be chosen. This requires that the first €63,500 of the pension fund, or the whole fund if it is less, must be invested so that the capital is not available to the individual until he or she attains the age of 75 (though any income generated by the fund can be drawn down subject to tax).

11.2 It is not possible to pay funds direct to an ARF. The funds must come from a Revenue approved pension arrangement for the individual taking out the ARF or from a deceased spouse. The ARF option can only be exercised by, and funded from, the following individuals/sources -

- a personal pension policy holder at any time prior to benefits becoming payable in respect of a policy (i.e. a retirement annuity contract);

- a 5% Director who is a member of an Occupational Pension Scheme at any time before the pension becomes payable;

[196] Alternatively an annuity can be purchased with the €63,500, with the balance of the fund, if any, invested in an ARF

- an individual who has made AVC contributions either to an employer's main scheme or to a separate AVC scheme (to the extent of those AVCs);

- the holder of a PRSA;

- the spouse of an ARF holder on the death of that individual; and

- the spouse or former spouse of a 5% Director where that spouse is entitled to an Occupational Pension Scheme benefit under a pension adjustment order[197].

No other individual may access the ARF regime. The ARF structure ceases to exist on the death of the main holder subject only to the surviving spouse continuing it. Assets can be transferred into an ARF from another ARF beneficially owned by the same individual.

11.3 Legislative rules and procedures apply in relation to the placing of funds into an ARF. Before transfer into an ARF can occur the funds must be certified by the institution holding the funds - that is by the insurer, trustee or other entity with which the pension was originally effected. The certificate will confirm, among other things, that the assets being transferred are ones to which the individual concerned is beneficially entitled following the exercise of the ARF option. Similarly, a declaration must be completed by the beneficial owner indicating his or her name, address and PPS number and also indicating that the funds are derived solely from a personal pension, PRSA or Occupational Pension Scheme as appropriate. The Qualifying Fund Manager must retain the certificate and declaration for the longer of a period of 6 years or three years after the fund ceases and Revenue are entitled to inspect the certificates and declarations and to take extracts or copies if necessary.

12. Investment rules applying to ARFs

12.1 Prior to Finance Act 2003 no restrictions were placed on the investment activities of an ARF. However, as a result of the 2003 Act, investment rules similar to the restrictions applying to SSASs were introduced. The rules operate, not by prohibiting particular transactions but, by rendering them tax inefficient through deeming them to involve distributions from the ARF and, therefore, liable to PAYE at the ARF owner's marginal rate of tax. In addition, an asset acquired in such circumstances is not treated as an asset for the purposes of the ARF, thus denying the asset the benefits of the gross-roll up regime and the special tax provisions applying to transfers on death of the ARF holder.

12.2 The main restrictions are:

- Loans to the ARF owner or connected persons.

- Acquisition of property from the ARF owner or connected persons.

[197] An order made to the trustees of a pension scheme by a Court in the course of a judicial separation or divorce action, or at any time after the making of a separation order or divorce decree, whereby the trustees must pay part of a member spouse's benefit to the non-member spouse.

- Sale of property to the ARF owner or connected persons.

- Acquisition of property for use as a residence or holiday home for the ARF owner or connected persons.

- Acquisition of tangible moveable property.

- Acquisition of shares or any other interest in a company in which the ARF owner or a connected person is a participator and the company is, or is deemed to be, a close company.

13. Analysis of Available Pension Information re High Earners.

13.1 As part of this review, an analysis was undertaken of available information within Revenue on the pension arrangements of certain high earners to establish, where possible, the nature and level of their pension funding having regard to the governing legislative rules and, where relevant, their use of ARFs.

13.2 In many of the cases examined, there was limited data available. However, there is some evidence in support of the following observations;

- Proprietary directors and executive employees can negotiate their earnings in the run up to retirement to maximise the final remuneration figure on which Revenue maximum benefits are calculated. The following example is of one individual whose salary has increased as follows;

2001	c. €300,000
2002	c. €500,000
2003	c. €1,000,000
2004	c. €1,000,000

  In case studies 1 and 2 in the ARF section following on page 23 there is evidence that, for the individuals involved, annual remuneration increased from a seven figure sum at the time the scheme was established to an annual average figure five times that amount, in the 36 month period immediately preceding retirement. (For reasons of confidentiality, the precise figures are not being published).

- Contributions to the occupational pension schemes of proprietary directors and executive employees are funded primarily by the employer and are, therefore, not affected by the age related 15 - 30% limits on contributions or by the annual earnings cap of €254,000. On the face of it, this would appear to limit the tax relief on such contributions to the corporation tax rate of 12.5%. However, arguably the most significant tax relief in relation to employer contributions is that they are specifically exempted (s.118(5) TCA 1997) from being charged as remuneration of the employees concerned, in the form of benefits-in-kind. One result of this tax exempt treatment of these benefits to employees is that the age and earnings-related restrictions on tax relief for pension contributions are by-passed: the age-related percentages and earnings cap do not apply at all to restrict the tax exemption of employers' contributions.

> In **Case Study 3** in the ARF section following, aggregate contributions of almost €14m have been made to two individual occupational pension schemes over a 9 year period, largely by the employer. To put this in perspective, given current limits for RACs and PRSAs, the maximum contributions that an individual could get tax relief on over a 9 year period would be €685,800.

> An analysis of Pensions Board registration forms of 50 single member DC insurance-based schemes first registering with the Board in October 2004, shows that 39 of the schemes were in respect of proprietary directors, 46 were funded by employer only contributions (i.e. premiums) and that the level of contributions was greatly in excess of the age related % limits and earnings cap applying to employee contributions to occupational pension schemes, RACs and PRSAs. In all but 3 cases the employer contribution exceeded 30% of salary while in 15 cases the employer contribution exceeded 100% of salary with the most extreme case showing a contribution of 500% of salary.

- The main "control" on over-funding, i.e. maximum benefits of two thirds final salary, is not linked to an absolute monetary cap and is effectively irrelevant in relation to proprietary directors and executive employees.

> The **Case Studies** in the ARF section following show that individual pension funds ranging in value from €6m to c. €100m can be built up which are actuarially within the maximum benefit requirements.

- Having regard to the size of some of the funds being built up, the current rules would appear to be allowing for more generous tax relief treatment than might have been originally intended by the legislature having regard to the purpose of tax relief for pensions, namely, the provision of pension benefits for individuals and their widows/widowers on retirement. This is borne out by the ARF case studies following.

- The present system, given the ARF option and current ARF rules, may be allowing certain individuals to take funds from companies in a tax efficient manner and to build up large pension funds in the knowledge that these assets can continue to accumulate in a tax-free environment in the ARF and can ultimately be passed on to the next generation in a tax-efficient manner. This is also borne out in the ARF case studies following.

14. ARF Examination

14.1 The Financial Services (Pensions) area of Revenue's Large Cases Division undertook an examination of all Qualifying Funds Managers (QFMs) providing ARF/AMRF services in the first part of 2005. The results of the examination in terms of numbers of ARFs/AMRFs in existence, amounts invested and types of withdrawal (regular or ad hoc) are summarised in the table following.

14.2 In summary, the following overall picture in relation to ARFs;

Summary of ARF Creation and Overall/Average Fund Size

	Number	*Total ARF Investment, €*	*Average Fund Size*, €*
ARFs Pre-FA 2000	118	19,155,309	162,333
ARFs Post-FA 2000	6048	1,114,601,012	236,796
Total	**6166**	**1,133,756,321**	**234,975**
Withdrawals			
Regular	**348**		
Ad Hoc	**290**		

*Note – to avoid distortion of the average ARF fund for post 2000 ARFs and ARFs overall, the number of ARFs used in the denominator has been adjusted from 6048 and 6166, respectively, shown in this table to 4707 and 4825, respectively, to reflect the fact that figures have been estimated for the number of ARFs managed by two particular Qualifying Fund Managers (QFMs) without corresponding estimates of the funds held by those QFMs in respect of those ARFs.

14.3 Points to note from the summary table are;

- There are in the region of 6,200 ARF funds with a total investment of over €1.1 billion
- The average amount invested in ARFs is €235,000 per fund.
- The overall average ARF fund size, however, masks a difference in average fund size as between ARFs managed by Life Offices and those managed by other QFMs.
- In the case of Life Office QFMs the average ARF fund stands at €148,000 (excluding 2 "super" ARFs referred to in case studies 1 and 2 following).
- In the case of Stockbroker/Bank QFMs, the average ARF fund stands at €661,000 (for 484 individual funds) but one fund at the higher end of the scale stands at €4.4m.

- There are little or no regular ARF drawdowns, with only 348 or around 6% of ARF funds being used to provide regular income and these are almost solely concentrated in the smaller funds managed by the Life Offices.

- The same applies to ad hoc withdrawals – with 290 or around 5% of ARF funds being used in that fashion, again mainly concentrated in Life Office managed funds.

- Assuming all ARF holders took their maximum lump sum of 25% of the value of the fund, the overall average tax free lump sum is around €78,000 while the average for ARFs managed by non-Life Offices is around €220,000.

14.4 The intention of the ARF legislation was to develop an alternative flexible income stream in retirement which would obviate the necessity for annuity purchase. Based on the evidence available (and in the absence of details on each individual ARF fund and the particular circumstances of each beneficial owner) it appears that this is not happening. Rather it could be said that ARFs have allowed the diversion of retirement provision into simple tax-advantaged savings schemes for those who do not need them to produce a regular income stream. That said there is no obligation on an individual to make withdrawals from his or her ARF. Also, as the ARF is a recent development, it may be that some individuals -

- are using the tax-free lump sum benefit to finance living expenses in the *initial* years of retirement,
- are continuing to work and earn an income,
- have more than one personal pension (e.g. a number of retirement annuity contracts) and may have used one for annuity purchase and chosen the ARF option in relation to the others,
- have other independent means.

The analysis does suggest, however, that for those who have the capacity to survive in retirement without the need to rely on funds invested in an ARF, our "EET"[198] system of pension taxation is much closer to an "EEE"[199] system where effectively no tax is paid, or if it is, it is at a low rate and far into the future.

14.5 The ARF examination undertaken by Large Cases Division did not, with one or two exceptions, extend to a general examination of individual ARF funds. However, in the context of the analysis of available information on the pension arrangements of certain high earners referred to earlier, information on a number of individual ARF funds and potential ARF funds came to light. There is no doubt that substantial funds are required if a high earning employee (including a proprietary director) is to be provided with a maximum two thirds pension with attaching spouse/dependant benefits and pension increases linked to inflation. Funding rates can dictate very large employer annual contributions if funding does not commence until the individual is older. That said, the following examples of actual and potential ARF arrangements raise questions not alone about the structure of the current ARF regime

[198] "EET" - exempt contributions, exempt growth of fund and taxed pension benefits.
[199] "EEE" - exempt contributions, exempt growth of fund and exempt pension benefits.

itself but also about the tax treatment of pension contributions in relation to those individuals, and the effectiveness of the legislation generally.

14.6 The most extreme cases can be summarised as follows:

Case Study 1

- SSAS set up.
- The value of the fund at retirement was c. €100 million.*
- 25%* of fund taken as tax-free lump sum.
- The remaining 75%* was invested in an ARF.

Case Study 2

- SSAS set up.
- The value of the fund at retirement was c. €100 million.*
- 25%* of fund taken as tax-free lump sum.
- The remaining 75%* was invested in an ARF.

Information available to date indicates that -

- in both cases all of the contributions to the SSAS appear to have been made by the employer company concerned;
- at the time the SSASs were set up, annual remuneration in respect of each individual was a seven figure sum*;
- at the time benefits were drawn down the average remuneration of each individual over the preceding 36 month period had increased by a multiple of five*;
- the actual benefits payable under both pension schemes <u>were actuarially well within the statutory maximum limits of two-thirds final salary;</u>

* For reasons of confidentiality the precise figure is not being published.

Case Study 3

- Contributions totalling almost €14m over 9 year period, mainly by the employer, to two pension funds administered jointly for several years and then split into two SSASs.
- Combined pension scheme assets valued at €20m in 2003
- Target funds at retirement to provide benefits within statutory maximum limits, are €35.4m and €43.6m respectively for the individuals concerned.

In this case study, assuming the target funds at retirement are met and that they are within the statutory maximum limits, there would be no obstacle to 25% tax-free lump sums of €8.9m and €10.9m, respectively, being taken at retirement and the remainder invested in ARFs.

Case Study 4

- SSAS
- Projected fund total for statutory maximum benefits €19.6m based on 2002 salary of €683,000.
- 2003 salary €1 million, therefore, projected fund value likely to increase substantially at next actuarial funding projection due in 2005, increasing value of likely ARF and tax-free lump sum.

Case Study 5

- SSAS
- The value of the fund at retirement was €5.9 million.
- The company contributed €4.4m in three year period.
- A tax-free lump sum of €1.5 million was taken.
- The remaining €4.4 million was invested in an ARF

14.7 The question must be posed in these cases as to whether the legislature ever intended that tax relief and funding rules be used to provide such significant pension benefits. The cases also highlight the need to consider whether the 25% tax-free lump sum rule requires to be amended so as to cap the absolute amount that can be taken in this way.

IV. CONCLUSIONS AND OPTIONS FOR CHANGE

15 Conclusions

15.1 The main conclusions from the foregoing analysis are as follows:

- Current tax reliefs appear to be too generous in relation to individuals whose employers are in a position to make substantial tax deductible contributions to their schemes without any earnings cap or age related % limits applying, particularly in circumstances where the individuals themselves are in a position to influence the level of employer contributions.
- While the rationale for granting tax relief on pension contributions is to ensure that individuals save for retirement, are not a burden on the State and can acquire a pension that takes some cognisance of their pre-retirement earning levels and lifestyle, the current regime which allows an individual to create a pension fund over a very short period with a closing value well within maximum benefit limits of c. €100 million, to take 25% of that as a tax free lump sum and place the remaining 75% in a tax exempt ARF, must be a matter of concern.
- The current regime of relief may be perceived to be inequitable in so far as more generous reliefs are available to those in occupational pension schemes (having regard to the absence of age-related % limits and an earnings cap on employer contributions) as compared with the self-employed using RACs or those relying on PRSAs.
- The "maximum benefits" rule of a pension of two thirds final remuneration appears to be ineffective in the absence of an absolute cap on the "salary" to which the 2/3rds rule is applied.
- The 3 year average rule for determining final remuneration may allow an increase in earnings in the run up to retirement to maximise the final remuneration figure on which maximum benefits are calculated.
- The ability to take a tax free lump sum of 25% of the value of the accumulated pension fund may be too generous when the value of the funds is substantial.
- The introduction of the ARF option in 1999, while meeting the goals of choice, control and flexibility, has (based on the available evidence to date) largely not been used to fund an income stream in retirement.
- The introduction of the ARF option would seem to be encouraging certain individuals to build up very substantial pension funds with a view to placing the funds long-term in the tax-exempt environment of the ARF.
- The introduction of the ARF regime may have undermined the "EET" system of pension taxation insofar as an individual with sufficient independent means can benefit from exempt contributions to a pension fund, gross roll up in respect of the income and gains of the fund, exempt transfer to and further gross roll up in an ARF and limited, if any, taxation on transfer on death.

16 Options for Change

16.1 In the interests of creating greater equity in the pensions tax relief system, limiting the Exchequer exposure from tax planning that does not have pension provision as its ultimate objective and addressing the particular problems relating to high earners, the following options for change could be considered. These changes are not aimed at the broad majority of occupational pension scheme members who are in no position to influence their remuneration or the level of contributions made by their employers and whose contributions and those of their employers are unlikely to generate pension benefits in the region of the maximum allowable. Rather the changes are aimed at proprietary directors and senior executive staff who are in a position to tailor their remuneration structure and the level of their employer's contributions so as to extract maximum benefits under the current regime.

16.2 The options are grouped into those that address:

A. contribution levels to occupational pension schemes eligible for tax relief, and
B. ARF issues.

Pros and cons applying to each option are then set out.

A. Contribution Levels eligible for Tax Relief

Option 1

Include employer contributions to occupational pension schemes within the age-related % limits and annual earnings cap of €254,000 applying to employee contributions.	
Pros	***Cons***
Would have no impact on the broad mass of ordinary occupational pension scheme members who are in no position to fund to maximum contribution levels and who cannot influence their remuneration or their employer's contribution levels. Therefore, would not unduly affect pension coverage	*Would effectively remove the ability of certain individuals to fund for maximum retirement benefits over very short periods through employer contributions as they would be forced into a "use it or lose it" situation in relation to relief. Proprietary director aged 55, wishing to retire at 65 with no previous pension provision could accumulate a maximum tax-relieved fund of €762,000 (ignoring investment growth). Any additional pension funding from current income would be from after-tax income.*
Would standardise the maximum tax relievable contributions as between OPSs, RACs and PRSAs.	*Would effectively remove the ability of an employer making maximum contributions to back-fund for an employee's past service on a tax-exempt basis.*

Would level the playing field as between different types of defined contribution pension provision.	*Could possibly adversely affect pension coverage but is unlikely to have any impact on most defined contribution OPS members.*
Would increase the degree of equity in the system as between users of OPSs, RACs and PRSAs and within OPSs as between those who can and those who cannot influence the payment of their remuneration as employer contributions to an SSAS-OPS.	*Transitional arrangements involving considerable lead-in time would be necessary to mitigate impact on individuals nearing retirement who had planned to fund for pension benefits over a short period.*
Could have positive Exchequer impact by reducing cost of pension tax relief for certain individuals.	*Could adversely hit company development and expansion by forcing entrepreneurs to fund earlier for pensions at a time when company resources may be better utilized to invest and expand the business.*
Would prevent the build-up of large individual tax-relieved pension funds which bring the system into disrepute.	
Would force individuals to plan for retirement provision over a longer period.	
	*Could give rise to particular problems for Defined Benefit schemes given the nature of the 'benefit promise'***.**

Option 2

Place an absolute cap on the size of the maximum tax-relieved retirement fund.	
Pros	***Cons***
Would be similar to UK simplification proposal of a lifetime allowance of £1.5m (€2.2m) for the tax year 2006/07 on relief for pension savings to be introduced from 6 April 2006.	*Depending on the level of the cap, could possibly adversely affect pension coverage but is unlikely to have any impact on most defined contribution OPS members.*
Would still allow an individual to fund benefits over a relatively short period and get tax relief up to the maximum retirement fund.	*If introduced from a current date, would impact on individuals nearing retirement who had planned to fund for tax-relieved pension benefits in excess of the limit over a short period. Therefore, transitional arrangements may be necessary.*

Would allow an employer to back-fund for employees' past service.	*Could complicate the regime as would require claw-back of relief or taxation of any excess tax-relieved contributions.**
Maximum fund limit going forward from operative date could be the actual value of an individual's fund on that date or the new limit, whichever is the greater. Thus tax relieved contributions and pension fund growth up to the operative date would be unaffected (but individuals whose fund value exceeds the new limit on the operative date would get no tax relief on further contributions to the fund).	

** In UK there will be a lifetime allowance tax charge on the excess value of the tax relieved funds over £1.5 million, at the rate of 55% if the excess is taken as a lump sum or 25% if used to purchase an annuity.*

Option 3

Place an absolute cap on the tax-free lump sum of 25% of fund value that can be taken from an occupational pension scheme.	
Pros	***Cons***
Would prevent very substantial lump sums of 25% of value of a pension fund being taken tax-free regardless of the size of the fund.	*Would simply increase the amount of the pension fund being placed in the tax-exempt environment of an ARF so, either way, there is no immediate tax benefit to the Exchequer.*
Would increase the Exchequer tax take where annuity is purchased with fund.	*Could, depending on the cut-off point and effective date, have an adverse impact on individuals nearing retirement who had planned financially for a lump sum of 25% of their fund value and who may have made commitments on foot of that.*
Would introduce greater equity into the system by reducing the capacity of wealthy individuals who obtained tax relief at 42% on pension contributions to extract large tax-free sums from their pension funds.	*Could possibly reduce pension coverage by reducing the attractiveness of pension provision but is unlikely to have any impact on most defined contribution OPS members.*
Would complement Option 2.	*Could be incorrectly represented as a pull-back from recently introduced tax changes which were designed to maximise choice and flexibility.*

Option 4

Cap the maximum final salary on which a pension can be based.	
Pros	***Cons***
Would make the current statutory maximum benefits rule effective.	*Could possibly act to reduce pension but is unlikely to have any impact on most defined contribution OPS members.*
Would bring greater equity and sense of fairness to the system while at the same time allowing for reasonable tax-relieved pension to be provided for.	*Would impact adversely on individuals who are funding for benefits in excess of the limit unless transitional arrangements involving considerable lead-in time were introduced in tandem.*
Would be likely to reduce the size of pension funds to the level required to actuarially provide for 2/3rds of the maximum salary.	
Would reduce perceived misuse of the ARF regime by reducing the likely size of pension funds.	

Option 5

Extend the averaging period over which final remuneration is calculated from 3 or more consecutive years ending not earlier than 10 years before the relevant date i.e. the date of retirement, to say 10 or more consecutive years.	
Pros	***Cons***
Would prevent contrived increases in salary in the run up to retirement so as to maximise benefits.	*Could impact adversely on those who cannot manipulate salary but yet would be forced to take a longer average measure (need to ensure that such individuals are not affected).*
Would encourage longer term planning for retirement.	*Verifying 10 year calculations may not be possible from Revenue records*

B. ARF issues.

Option 6

Introduce an annual flat-rate tax charge on the value of an ARF fund or on the undistributed income and gains of an ARF fund.	
Pros	***Cons***
Such charges are already a feature of the tax system – i.e. the annual Discretionary Trust Tax charge on the value of trust assets	*Could add complexity to the ARF tax regime which was simplified to the gross roll-up approach in 2002 because the original taxing regime proved too cumbersome.*
Would guarantee some tax take from ARFs and therefore sustain the EET principle.	
Annual tax charge could be credited against tax actually paid on distributions from the ARF to avoid double taxation.	
May help to reduce the incidence of large ARFs.	
Charge could be tailored to apply to ARFs over a particular value.	*If larger ARFs are targeted, it could give rise to the splitting of ARFs into smaller ones to avoid the tax on notional distributions – therefore, ARF size-trigger might have to be a cumulative one.*
Properly pitched, the taxing threshold would be unlikely to impact on the majority of ARF holders with relatively modest investments.	

Option 7

Deem a notional annual distribution to be made from an ARF on the basis of a set return of say 3% per year on the value of the ARF. The notional distribution to be taxed at the ARF owner's marginal rate of tax.	
Pros	***Cons***
Would guarantee some tax-take from ARFs and sustain the EET principle.	*If larger ARFs are targeted, it could give rise to the splitting of ARFs into smaller ones to avoid the tax on notional distributions – therefore, ARF size-trigger might have to be a cumulative one.*
Would act to discourage the creation of large ARF funds.	*Would add complexity to the ARF tax arrangements.*
Charge could be tailored to apply to ARFs over a particular value or where more than one ARF is held the value limit would be applied to the cumulative value.	
Annual tax charge could be credited against tax actually paid on distributions from the ARF to avoid double taxation.	

Option 8

Treat transfers from an ARF to an adult child on the death of the ARF holder as income of the deceased in the year of death.	
Pros	***Cons***
Could increase the tax take in respect of distributions to adult children (currently subject to a final liability tax at the standard rate of 20%) where deceased's marginal rate of tax in year of death is at the higher rate of 42%.	*Would be a reversal of the current tax treatment.*
Would make the use of the ARF regime for tax planning purposes less attractive.	*Would encourage transfer on death to a spouse so as to further postpone the payment of tax.*

Option 9

Place an upper limit on the amount of employer contributions to a pension fund that can be placed "tax-free" in an ARF - effectively requiring employer contributions above the limit to be taken at retirement as a taxable lump sum or used to purchase an annuity.	
Pros	***Cons***
Would restrict the amount of employer contributions as annuities are not "good value".	*Would add further complexity to the pension/ARF regime.*
Depending on the limit set, the majority of ARFs would be unaffected.	*Could possibly adversely affect pension coverage but is unlikely to have any impact on most defined contribution OPS members.*
Would help prevent the build up of large individual tax-relieved pension funds which bring the system into disrepute.	*If introduced from a current date could adversely affect individuals nearing retirement who had planned to take the ARF option under current arrangements.*
Could have positive Exchequer impact by reducing the cost of pension tax relief for certain individuals.	*Would represent pull-back from only recently introduced tax changes which were designed to maximise choice and flexibility.*
Would reduce perceived misuse of the ARF regime by reducing the likely size of pension funds.	*Would reintroduce compulsion to purchase poor value annuities in certain instances.*

Glossary

Additional Voluntary Contributions (AVCs)	Extra contributions which an occupational pension scheme member decides to make in order to increase his benefits.
Annuity	A series of regular payments payable throughout the life of the beneficiary (and possibly his dependants).
Approved Retirement Fund (ARF)	A fund managed by a *qualifying fund manager* in which certain persons can invest the proceeds of certain pensions on retirement.
Buy-out bonds	The purchase by trustees of a pension scheme of an insurance policy in the name of a member or other beneficiary, in lieu of entitlement to benefit from scheme, following termination of the member's pensionable service.
Deferred benefits	Benefits payable by an occupational scheme at retirement to or in respect of a member who has left the scheme before normal pensionable date.
Defined benefit scheme	An occupational scheme where the member's benefit entitlement at retirement is defined in some way by reference to his salary or wage, an index or a fixed amount.
Defined contribution scheme	An occupational scheme where the member's benefit entitlement at retirement or leaving service is determined by reference to the accumulated fund.
Personal pension	See Retirement annuity contract.
Personal Retirement Savings Account (PRSA)	The PRSA is an investment account owned by the individual. The account holds units in investment funds that are held with and managed by an approved PRSA provider.

Portability	The ability to transfer benefit entitlements from one occupational pension scheme to another on changing jobs without significant penalty.
Qualifying Fund Manager (QFM)	A financial institution qualified under the tax legislation to operate *Approved Retirement Funds* (ARFs).
Retirement Annuity Contract (RAC)	A contract effected with an insurance company under chapter 2 Part 30 of the Taxes Act. Applicable to the self-employed and to persons in non-pensionable employment sometimes called a 'personal pension'.
Small self-administered pensions schemes (SSASs)	Type of occupational pension scheme (typically single member schemes) where special Revenue requirements apply in relation to their approval, operation and supervision.
Transfer value	The amount of money payable to another Occupational scheme generally on changing jobs in lieu of benefits earned in the member's former employment.
Vesting period	A period during which there is no entitlement to benefit from an employer's pension contributions in the event of leaving service.

Appendix G.1

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<u>Appendix G.2</u>

Current Rules for Funding Pension Benefits

The maximum benefit on retirement at normal retirement age is detailed at paragraphs 6.4 and 6.6 of the Revenue Pensions Manual, as follows:

6.4 The aggregate benefits payable to an employee who retires at *normal retirement age* after 40 or more years' *service* with the same employer, when expressed as an annual amount payable for life (or for life subject to a guaranteed minimum period not exceeding 10 years) and taking into account any benefits paid as lump sums, should not exceed 2/3rds of his *final remuneration*. A basic maximum accrual rate of 1/60th of *final remuneration* for each year's *service* is approvable for any period of *service* of 40 years or less (a pension on this basis is commonly described as a pension of N/60ths).

6.6 Late Entrants: Benefits in excess of those which would be produced by a basic rate of 1/60th of *final remuneration* for each year of *service* can normally be approved under Pensions Business Unit discretion for employees who cannot, by reason of the date of their entry to employment, complete 40 years' *service* before *normal retirement age*. A pension of two-thirds of *final remuneration* cannot be approved for very short periods of *service* but, subject to any deduction required for *retained benefits* from previous employment, approved schemes may provide a pension of two-thirds of *final remuneration* for *service* of not less than 10 years to *normal retirement age*. An improvement on an accrual rate of 60ths is usually also permissible for employees with between 5 and 10 years' *service* to *normal retirement age* as in the following scale known as "uplifted 60ths":

Maximum Pension

Years of *service* to normal retirement age	**Expressed as a fraction of maximum approvable pension for a full career**	**Expressed as a fraction of final remuneration**
1 - 5	1/40th for each year	1/60th for each year
6	1/5th	8/60ths
7	2/5ths	16/60ths
8	3/5ths	24/60ths
9	4/5ths	32/60ths
10 or more		40/60ths

Final remuneration is defined in the *Glossary* to the Revenue Pensions Manual as follows:

(i) (a) Basic remuneration over any twelve month period of the five years preceding the relevant date (i.e. the date of retirement, leaving *service* or death, as the case may be),

PLUS

(b) The average of any fluctuating emoluments over three or more consecutive years ending on the last day used in (a) above.

(ii) The average of the total emoluments for any three or more consecutive years ending not earlier than 10 years before the relevant date.

(iii) The rate of basic pay at the relevant date or at any date within the year ending on that date plus the average of any fluctuating emoluments calculated as in (i) above.

Provided that-

(i) Basis (iii) cannot be used where within three years before the relevant date an employee:

(a) was promoted or received a special increase in basic pay, and

(b) the total increase over the relevant three year period is greater than it would have been if the remuneration on the day of commencement of the period had been increased proportionately to the increase in the Consumer Price Index, or to increase applicable to the employment under a National Wage Agreement, during the same three year period.

However, it is possible to agree beforehand with Revenue that such increases, if given on a recognised scale applicable to defined groups of arm's-length employees, will not prevent the availability of basis (iii).

(ii) Whenever *final remuneration* is calculated by reference to a year or years other than the 12 months ending with the relevant date, each such year's remuneration may be increased in proportion to the increase in the cost of living from the last day of that year up to the relevant date referred to as "dynamised" *final remuneration*. This also applies to fluctuating emoluments so that fluctuating emoluments of a year other than the twelve months ending with the relevant date may be increased as detailed above.

(iii) In the case of a *20% director* -

(a) the scheme may not adopt either of the bases (i) or (iii), and

(b) Proviso (ii) above may not be applied unless it can be shown to the satisfaction of Revenue that the amount of the non-commutable pension payable or remaining payable or payable before the application of rules permitting commutation of the whole of the benefits to the director is not less than two-thirds of the annuity equivalent of all retirement benefits payable to the director (or to which he is entitled) under all schemes of the employer at the time any lump sum benefits are to be paid to him under the rules.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section H:

Patent Royalty Exemption Scheme – Sections 141 and 234 of the Taxes Consolidation Act 1997

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1 EXECUTIVE SUMMARY

1.1 In 1973, a tax exemption was introduced for income from certain patents to encourage research and development (R&D) in Ireland and to stimulate inventions. The policy aim of this 1973 measure is equally as important in today's economy where Ireland seeks to 'move up the value chain'. However there is a lack of data on the range and nature of benefits of this relief. Consultations between Government Departments and agencies will take place regarding an improved data collection system in relation to the relief. A balance will have to be struck between gathering sufficient information for evaluation purposes while not overburdening claimants of the relief with excessive administrative requirements.

1.2 Some possible minor amendments to the scheme are presented in the conclusions. One amendment seeks to close down a specific tax avoidance scheme involving franchising and another amendment seeks to tighten up an anti-avoidance provision in the case of distributions where connected parties are involved. Further recommendations were considered in the course of the review but they are provisional pending the availability of more detailed data and discussions.

2. INTRODUCTION

In his Budget Statement of 1 December 2004 the Minister for Finance, Mr Brian Cowen, TD, announced that the Department of Finance and the Revenue Commissioners would undertake a detailed review of certain tax incentive schemes and exemptions in 2005. This review examines the patent royalty exemption (PRE) scheme and broadly assesses the contribution that the relief has made or can make to the wider policy objectives of the sector in which the relief applies.

3. OVERVIEW OF THE SCHEME

History and objectives of the scheme

3.1 In the 1973 Budget the then Minister for Finance announced a 'tax relief for inventors who contribute to industrial development and improved competitiveness.' The 1973 Finance Bill provided for an exemption from tax of income from certain royalties '*to encourage research and development in Ireland and to stimulate inventions*[200]'. The Minister announced to the Dáil that:

'*…it is a most significant section which I believe will have far-reaching beneficial effects in stimulating research and development in this country. One of the possible disadvantages from which we have suffered as a result of particular disciplines we applied in industrial development over the last couple of decades*

[200] Extract from the Financial Statement, 1973

is that it was of a kind that did not encourage research, development and inventiveness in Ireland. We tended rather to accept into Ireland, and apply here a certain amount of research and inventiveness elsewhere. ... We have every reason to believe that as a result of this we shall be able to bring to Ireland a great deal of research and development activity which otherwise would not come here.'[201]

The original legislation

3.2 Royalty income in respect of certain patents is not subject to income tax in the hands of the inventor who holds the patent. Where the patent is held by a company, the royalties received by the company are not charged to corporation tax. Moreover, dividends paid out by the company from its tax-free royalty income are also tax-free in the hands of the shareholders.

3.3 In 1973[202] the tax exemption for certain patent royalty income was originally introduced for inventors (both individuals and companies) who contributed to R&D in Ireland. The Corporation Tax Act of 1976[203] extended the scheme to distributions made by a company (to both individuals and other companies) out of income which is itself exempt patent royalty income. The exemption for distributions is maintained as each recipient company in a chain distributes in turn.

3.4 Essentially, the tax exemption relates to certain income from 'qualifying patents'. A 'qualifying patent' is defined as "a patent in relation to which the research, planning, processing, experimenting, testing, devising, designing, developing or similar activity leading to the invention which is the subject of the patent was carried out in the State"[204].

Modifications

3.5 The Finance Acts of 1992[205] and 1994[206] refined the patent royalty exemption scheme to curtail what were perceived to be abuses of the scheme.

3.6 The 1992 restrictions limited the dividend exemption to dividends paid by the patent holding company in respect of shares (referred to as "eligible shares") forming part of its ordinary share capital and which have no special rights or privileges.

3.7 Finance Act 1994 limited the relief by excluding royalties derived from non-manufacturing activity where the payments are made between connected

[201] Dail Debates – Volume 267 – 26 July 1973
[202] Section 34 of Finance Act 1973, now section 234 of the Taxes Consolidation Act 1997
[203] Section 170 of the Corporation Tax Act 1976, now section 141 of the Taxes Consolidation Act 1997
[204] Section 234 of the Taxes Consolidation Act 1997
[205] Section 19 of the Finance Act 1992
[206] Section 28 of the Finance Act 1994

persons[207]. This restriction was introduced to counter abuses of the relief, which had come to light in the services sector. To qualify for the relief an individual or company must have carried out the research and development which led to the invention and the patent royalty must be paid for the purposes of manufacturing activity or by an unconnected party.

3.8 The 1996 Finance Act[208] introduced further restrictions on the relief to counter the relief being used to reward key directors/employees in a tax efficient manner without any clear benefit to the economy from greater R&D activity. The Act introduced, in particular, an arms-length test for payments between connected persons involved in manufacturing activity by providing a ceiling on the carry through of the relief to shareholders, unless the patented invention involved radical innovation. Revenue have to be satisfied that radical innovation is involved and in making this determination Revenue may consult outside experts, otherwise the ceiling applies. The ceiling is the group expenditure on research and development incurred in that accounting period and the previous two accounting periods. Thus, a company in the group, which is in receipt of patent royalty income and is incurring on-going R&D expenditure, can only make tax-free distributions out of the patent royalty income up to that ceiling.

Features of the scheme

3.9 The salient aspects of the scheme as presently constituted are:

- **Qualifying patent**
    - A "qualifying patent" is a patent where the work which gives rise to the invention which is patented is carried out in the State[209].

- **Income from a qualifying patent**
    - "Income from a qualifying patent" is any royalty or other sum paid in respect of the user of the invention to which the qualifying patent relates and includes any sum paid for the grant of a licence to exercise rights under the patent.
    - Where the royalty or other sum is paid for the purposes of certain activities, principally manufacturing and deemed manufacturing[210], and where the payer is connected to the recipient, the amount qualifying for exemption is restricted to such amount as would not exceed the amount which would be paid by persons acting at arm's length.

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[207] 'Connected person' is broadly a member of the same group of companies or a person who controls a company either in their own right or in association with other persons who are themselves connected with the first person.

[208] Section 32 of the Finance Act 1996

[209] The Revenue guidance notes to the Taxes Consolidation Act 1997 (2003 edition p. 325) indicate that the exemption is still available in the case of genuine inventions researched and developed in Ireland where, of necessity, some of the research may have had to be carried on outside the State (e.g. tests made abroad in particular climatic or other circumstances).

[210] That is, activities that would have qualified for the 10% scheme of corporation tax provided for by Part 14 of the Taxes Consolidation Act 1997 (including such activities carried on by an unincorporated person or carried on outside the State). Not included are financial service activities carried on in the IFSC or Shannon Zone.

- Patent royalties paid for other purposes may also qualify for the exemption where the payer is not connected with the recipient of the royalty.
- Relief for patent royalty payments is not available if the payer is a connected non-manufacturing company.

- **Exemption for income from a qualifying patent**
  - An Irish resident individual or company on making a claim is entitled to have any "income from a qualifying patent" disregarded for the purposes of the Tax Acts.
  - An individual in receipt of income from a qualifying patent is not entitled to have that income treated as exempt income unless the individual carried out, either solely or jointly with another person, the research, planning, processing, experimentation, testing, devising, development or other similar activity leading to the invention which is the subject of the qualifying patent.

- **Exemption for distributions made by a company out of exempt royalty income**
  - Distributions made out of income from a qualifying patent (other than distributions referred to in the next bullet) which have been disregarded for income tax or corporation tax purposes are themselves disregarded for the purposes of corporation tax or income tax to the extent that such distributions are made to another unconnected company or are made in respect of eligible shares. Moreover, persons who were actually involved in the devising of the invention giving rise to the patent are also entitled to tax exempt distributions out of exempt royalty income.
  - In the case of distributions made by a company out of exempt patent royalties received from a person (connected with the company) carrying on manufacturing or deemed manufacturing, the quantum of patent dividends to be treated as exempt is limited by reference to R&D expenditure incurred by the company, and its group companies, over a three-year period. This limit does not apply where the patent involves 'radical innovation' and the patent was not registered primarily for the purpose of avoiding liability to taxation.

Patents

3.10 A patent confers upon its holder, for a limited period, the right to exclude others from exploiting (making, using, selling, importing) the patented invention, except with the consent of the owner of the patent.

3.11 A patent is a form of 'intellectual property', which can be assigned, transferred, licensed or used by the owner. Patents are territorial in effect e.g. an Irish patent is only valid in Ireland.

3.12 Irish patents, in common with most jurisdictions, have a maximum life span of twenty years. Ireland also offers a 'short-term' patent, valid for a maximum of ten years. These short-term patents are designed to assist smaller inventors and suit inventions where a shorter market life is expected, or inventions that are not technologically complex. A full information booklet on patents in Ireland is attached at Appendix H.1.

3.13 It is not an essential requirement that the patent be an Irish patent – the definition of "qualifying patent" in section 234(1) would also include foreign patents where the research work, etc. leading to the invention was done in the State.

4. POLICY BACKGROUND

Current policy objectives

4.1 The objectives of the Patent Royalty Exemption (PRE) seem to be consistent with current economic and industrial policy objectives where the emphasis has been in recent years on 'moving up the value chain' and building a knowledge economy.

4.2 Details of this policy are most recently set out in the report of the Enterprise Strategy Group, *Ahead of the Curve*, *Ireland's Place in the Global Economy,* July 2004. According to the report, the current profile of enterprise expertise in Ireland shows significant expertise in manufacturing/operations and limited capability in R&D and sales and marketing. Our traditional expertise in the areas of manufacturing and operations however faces significant challenges from India and China and is probably not sustainable in the future. Knowledge is increasingly a driver of economic development and an influencer of new products. The Enterprise Strategy Group report suggest that firms in Ireland must complement their existing production and operational strengths by inter alia, building technological and applied R&D capability to support the development of high-value products and services.

4.3 The EU[211] has set a target for R&D expenditure to increase from 1.9% to 3% of GDP by 2010, of which two-thirds should be met by the private sector. At present, according to the 2003 data available from Forfás, Ireland is below the EU average expenditure on R&D at 1.4% of GNP compared to the EU's average of 2%. In 2003, Business Expenditure on R&D was €1,075m or 0.97% of GNP, compared to EU 1.13% and OECD 1.45%. State grants amounted to about € 35m or 3.3% of BERD.

4.4 The publication "*Building Ireland's Knowledge Economy – The Irish Action Plan for promoting Investment in R&D to 2010*" (June 2004), argues that "sustained investment in R&D is an essential foundation to maintain the competitiveness of the enterprise base and to develop Ireland as a knowledge based society, so as to increase productivity growth, provide a source of opportunity in new growth areas and to develop a basis for creating knowledge driven competitive advantage across all sectors of the economy". The report maintains that Ireland needs to take steps to increase its levels of expenditure on R&D, and the patent royalty exemption and recently introduced R&D tax credit are expected to play an important role in encouraging companies to increase the levels of innovation activity to achieve this target.

[211] Barcelona European Council, March 2002

4.5 The report concludes that "the determinant of Ireland's future economic well-being will be its success in stimulating business to do more R&D, promoting innovation and a culture of entrepreneurship amongst researchers and fostering effective linkages between enterprise and academia." The Action Plan calls for the creation of a national pro-innovation culture supportive of invention, risk-taking and entrepreneurship and the development of a new and less bureaucratic approach to R&D support that encourages a systematic and continuous approach to R&D within enterprises. The Action Plan set a target that business expenditure on R&D should increase from €917m in 2001 to €2.5 billion in 2010.

State Supports for R&D in the Business Sector

4.6 The *Enterprise Strategy Group* reported in July 2004 that Ireland has taken a number of significant steps to recognise the importance of R&D, including:

- Allocating €2.5 billion in the National Development Plan (2000-2006) to R&D and innovation
- Establishing Science Foundation Ireland and the Programme for Research in Third Level Institutions.

4.7 The current funding compares with a government spending of €0.5 billion in the period 1994–1999. R&D in the business, higher education and public research institutions increased three-fold during the 1990s. Business expenditure on R&D reached €1,075m in 2003.

State Grants for Business R&D

4.8 Up until 1992 there was only one mechanism available for grant-aiding R&D in industry. This was the Product and Process Development Grants Scheme operated by the Industrial Development Agency (IDA). Some, but not all, of this went to support R&D projects in industry but no independent evaluation of this was ever done.

4.9 In 1992 a new mechanism was introduced by the Office of Science and Technology in the Department of Enterprise, Trade & Employment (DETE), funded entirely by Structural Funds. This was initially called 'Measure 6', as it was one Measure of the Operational Programme (OP) then in place. This was the source of the large increase recorded in 1993 in state support for BERD. It continued in operation until the end of the last OP (1999) and was operated by Forbairt/Enterprise Ireland (EI). It never again achieved the levels recorded in 1993[212] and by the end of the decade it amounted to €30m (c. £24m) per year.

4.10 For the National Development Plan (NDP) introduced in 2000 there are two R&D support schemes for industry – the Competitive Research & Technological Development & Innovation (RTDI) Scheme (known as RTI) and the R&D Capability Scheme. The RTI scheme is open to both indigenous and foreign-owned firms and has a target in the OP of €180m for the period 2000-2006, approximately €25m per year.

[212] State support in the form of grants amounted to IR£32 (€41) in 1993.

4.11 There are two Capability Schemes, one operated by IDA for foreign firms and one by EI for their clients. The EI scheme has a total budget for 2000-2006 of €91m. The IDA scheme would appear to have a budget of around €10m per year.

Fiscal supports for R&D

4.12 Nine specific fiscal supports for R&D, including the patent royalty exemptions, have been identified by this review. These supports are in addition to the normal tax deductions available to a person who engages in R&D activity for the purposes of their trade or business.

The R&D tax credit:

4.13 Finance Act 2004[213] introduced a 20% tax credit for incremental expenditure on R&D. The credit is in addition to any normal tax deduction available to a company for R&D expenditure. The credit can be offset against a company's corporation tax liability for the current year and any unused credit can be carried forward indefinitely against the corporation tax liability for subsequent accounting periods of the company until it is used up. The scheme is an incremental one whereby expenditure in excess of a defined base can qualify for the credit. For the first three years of the scheme (i.e. 2004 – 2006) the base is R&D expenditure incurred in 2003. Thereafter, there is a rolling one year base i.e. for 2007 the base is expenditure incurred in 2004 and for 2008 the base will roll on to expenditure incurred in 2005 and so on. The base is calculated and apportioned on a group basis and a group can elect how to share the credit among group members. An amount equal to 20% of the incremental spend apportioned to a company is then available to reduce the corporation tax of that company or of group companies, as appropriate.

4.14 Where a company that incurs expenditure on carrying out R&D activities also pays a sum to a university or institute of higher education in the EEA for that university or institute to carry out R&D for the company, the sum so paid, up to an amount that does not exceed 5 % of the expenditure incurred on R&D activities carried out by the company, will qualify for credit.

4.15 The Finance Act 2004 also provides that where a company incurs relevant expenditure on the construction or refurbishment of a building or structure which is to be used for the carrying on by it of R&D, the company is entitled to a tax credit of 20% of the cost of construction or refurbishment but this will be allowed over a period of four years as a credit against corporation tax. Relevant expenditure on a building or structure is expenditure on the construction of a building or structure which qualifies for capital allowances in the State but does not qualify for the relief in any other territory.

4.16 The tax credit only came into operation for expenditure incurred from 1 January 2004, therefore it is too early to evaluate the effects of this tax credit. The relationship between this tax credit and the PRE remains to be examined. At this stage, given the lack of data for a cost benefit analysis, it is difficult to

[213] Section 33 of the Finance Act 2004 inserted by sections 766 and 766A into the Taxes Consolidation Act 1997

come to a conclusion on this issue. Forfás and the agencies argue that the patent royalty exemption complements the R&D tax credit.

Expenses incurred in devising an invention[214]:

4.17 A tax write-off is available for the fees and expenses incurred in devising a patented invention and also of the fees and expenses incurred in obtaining the grant of a patent or the extension of the term of a patent. The write off is independent of any trade or business the person may or may not be carrying-on and the allowance is made for the year in which the expenditure is incurred and for the full amount incurred in that year. In other words, these deductions are available whether or not the person is carrying on a trade and whether or not the invention is devised for the purposes of a trade carried on by the person.

Non-capital expenditure on scientific research[215]:

4.18 A person carrying on a trade is entitled to deduct non-capital expenditure on scientific research in computing profits or gains of the trade. The scientific research does not have to be related to the trade carried on by the person.

Capital expenditure on scientific research[216]*:*

4.19 A person carrying on a trade is entitled to an allowance in respect of capital expenditure on scientific research relating to the trade. The allowance is also available when the expenditure has been incurred before the start of trading. The full allowance is available for the period in which the expenditure is incurred. There is a bar on double allowances; unused allowances can be carried forward. The allowance is also available where the capital expenditure is not related to the person's trade.

Donations to certain bodies to undertake research[217]*:*

4.20 A deduction may be taken for capital or revenue sums paid to approved bodies or Irish universities for the carrying on of scientific research.

Stamp duty exemption for sale of intellectual property[218]:

4.21 An exemption from stamp duty on the sale, transfer or other disposition of intellectual property is available. Intellectual property is defined as including any patent. Any contract or agreement for sale, any licence or mortgage, of such intellectual property, is covered by the exemption. Applications for the grant or registration of such items, and goodwill to the extent that it is directly attributable to such intellectual property are also included.

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214 Section 758 of the Taxes Consolidation Act 1997 refers.
215 Section 764 of the Taxes Consolidation Act 1997 refers.
216 Section 765 of the Taxes Consolidation Act 1997 refers.
217 These deductions are available under both section 764 and section 848A of the Taxes Consolidation Act 1997.
218 Section 101 of the Stamp Duty Consolidation Act 1999 refers.

Business Expansion Scheme (BES) and Seed Capital Scheme (SCS)[219]:

4.22 The BES provides an income tax deduction for individuals investing in certain companies. The total amount a company may raise qualifying for BES relief cannot exceed €1,000,000 and each individual investor is limited to an income tax deduction of €31,750 in any one year. Excess relief can be carried forward and, subject to the cap applying in subsequent years, taken in subsequent years. In the case of the SCS a similar limit on the amount a company may raise which qualifies for relief applies, but individual investors may get tax refunds in the year they invest based on the tax they paid over the previous 6 years subject to a limit on relief of €182,240 (assuming a constant 42% rate of tax, this gives a tax refund of €76,540 per investor). The SCS is designed to encourage individuals to leave paid employment and set up new businesses. There are limits on the number of investors per company.

4.23 Under both schemes, research and development activities qualify for relief under two distinct headings. Firstly, research and development undertaken by a company in advance of starting to trade as a manufacturer or provider of certain services. Secondly, dedicated research and development companies that invent or develop a product or service and sell it on for exploitation and move on to develop further inventions.

4.24 **Table 1** sets out the use made of the BES for R&D activities for the years 2002 to 2004. At this stage Revenue data cannot show whether any of the individuals who made a BES or SCS investment in a R&D company are also in receipt of tax exempt patent royalties. It would be useful to see whether the individuals who are investing in start-up and small dedicated R&D companies are accessing the patent royalty exemption to any extent. It may be possible to make such comparisons once the 2004 tax return data is received and processed.

Table 1: BES – No. of companies and investors in R&D 2002 to 2004[220]

Year	Companies	Investors
2002	17	104
2003	6	58
2004	15	75

4.25 **Table 2** gives the same information for the SCS for all years since its inception in June 1995. In addition, the total of tax refunds made in respect of new R&D companies established, or companies established initially to carry on R&D activity, under the SCS is given.

[219] Both reliefs are contained in Part 16 (Income Tax relief for investment in corporate trades – Business Expansion Scheme and Seed Capital Scheme) of the Taxes Consolidation Act 1997.
[220] Source: Revenue Commissioners.

Table 2: SCS No. of companies, investors and amount refunded all years[221]

Companies	Investors[222]	Tax refunds
14	17	€372,914

Use of fiscal measures in other countries

4.26 Countries use a range of fiscal measures to promote R&D. As Table 2 from the 2004 report of the EU Fiscal Measures for R&D sub-group[223] shows, most countries (16 out of 17) provide some form of tax incentive related to general R&D costs and investment. Just under half of the countries (8 out of 17) use measures specifically to promote patents and intellectual property. Seven countries also use fiscal measures to support research foundations (or similar bodies). Eight countries use fiscal measures to promote the employment of researchers and improve research careers.

Table 3: countries with fiscal measures by general aim of measure[224]

	R&D costs and investment	Research careers	Research Foundations	Patents and intellectual property
Austria	Y		Y	Y
Belgium	Y		Y	Y
Denmark	Y	Y	Y	
France	Y	Y		
Hungary	Y	Y	Y	Y
Ireland	Y			Y
Israel	Y	Y		Y
Italy	Y	Y		
Latvia	Y			
Lithuania	Y	Y	Y	
Netherlands	Y			
Norway	Y			
Portugal	Y	Y		Y
Romania	Y			Y
Spain	Y			Y
Sweden		Y	Y	
UK	Y		Y	
TOTAL	16	8	7	8

[221] Source: Revenue Commissioners.

[222] In contrast there were 401 investments in manufacturing; 321 in services; 44 in IFSC; 32 in tourism and 13 in mushrooms.

[223] Extract from the Expert Group on Fiscal Measures for Research Report submitted to EU scientific advisory group CREST in June 2004. http://europa.eu.int/comm/research/era/3pct/pdf/crest-g3-final_en.pdf#view=Fit

[224] Source: Question 1 of questionnaire to participants of the Fiscal Measures for R&D sub-group.

4.27 Details of the measures aimed at 'patents and intellectual property' were not included in the above mentioned report but it seems that the design of Ireland's measure whereby the income from a patent is exempt from tax contrasts to the design of some other measures such as that in Austria whereby the relief granted is an allowance for the R&D leading to the patent.

5. THE ECONOMIC RATIONALE FOR THE PATENT ROYALTY EXEMPTION SCHEME

Market Failure

5.1 It is clear from the previous section that a key strand of government economic policy is to encourage R&D and that the government has to date implemented various policies to achieve this end. In economic terms, government support for scientific research is justified by the presence of a market failure as research and development (R&D) shares some of the characteristics of a public good. Much of the knowledge that is created from scientific research and its associated economic benefits do not accrue solely to the economic actors that make the initial investment; these benefits spill over to others in society. That is to say, the social returns (returns to the overall society) are greater than the private returns (returns to the investor). The results of empirical economic studies supporting this contention are presented in **Table 4** below. As the incentive to undertake research depends on these private economic returns, firms will under-invest in research from a national perspective, as not all of the social returns will be captured by the firm. This justifies government intervention if it can correct this market failure.

Table 4: Estimates of returns from R&D activity[225]

	Estimated Rates of Return (%)	
Author (Year)	**Private**	**Social**
Nadiri (1993)	20–30	50
Mansfield (1977)	25	56
Terleckyj (1974)	29	48-78
Sveikauskas (1981)	10–25	50
Goto-Suzuki (1989)	26	80
Bernstein & Nadiri(1988)	9–27	10-160
Scherer (1984)	29-43	64-147
Bernstein & Nadiri (1991)	14-28	20-110

5.2 One key form of government intervention is a patent. This grants exclusive use of the new knowledge to the discoverer for a limited period of time, preventing the spill over of benefits to others in the medium term. This ‘capture’ of the benefits increases the incentive for private individuals / companies to invest in research. The problem with patents is the difficulty of determining the appropriate life of a patent. The longer the life of a patent the greater the return to the innovators and hence the greater the incentives for

[225] Source: “Competing in the Global Economy – The Innovation Challenge”, DTI, 2003.

innovation; conversely, however, the knowledge produced will be used inefficiently by a monopoly for a longer period of time. For this reason patents only partially solve the market failure and other policies, including perhaps fiscal instruments, are needed.

5.3 An exemption from tax on income from patents, the PRE scheme of this report, increases the incentive for innovation without prolonging the inefficient monopolistic use of the innovation.[226] A company would normally pay 12.5% tax on its income, and therefore only keep 87.5% of it. This exemption means a company now receives all 100%.

Empirical Evidence

5.4 Turning to the empirical evidence on the success of these government interventions, no information is available on the evaluation of the patent income exemption. A range of empirical work exists, however, on the effect of other fiscal incentives, such as an R&D tax credit, in encouraging R&D activity. A review article by Hall and Van Neenan (Research Policy, 2000) finds that different studies using different methodologies and focusing on different countries draw reasonably similar conclusions: a dollar of tax credit for R&D stimulates a dollar of additional R&D. More recent work by Bloom, Griffith and Van Neenan (Journal of Public Economics, 2002) examines data for nine OECD countries over a nineteen-year period. It estimates that a 10% fall in the cost of R&D, due to tax incentives, stimulates a 1% rise in the level of R&D in the short run and nearly a 10% rise in R&D in the long run. While the patent income exemption cannot be easily placed in the framework, as it works by increasing the benefits of successful R&D activity not by decreasing costs, this does show the responsiveness of R&D activity to fiscal incentives.

5.5 However, fiscal incentives do not completely solve failures in the market for knowledge by themselves. The market failure is due to social returns being greater than private returns. Thus from a social viewpoint those projects with the largest gaps between social and private returns should be funded. Yet fiscal incentives such as an R&D tax credit will stimulate private sector firms to fund R&D projects with the highest private rates of return. Thus, from a national perspective, some projects that should be funded will now be funded, however the best projects may still not be funded.

5.6 This point highlights the importance of a suite of R&D supports. Patents and a patent income exemption can at least partially avoid this issue by attempting to capture the social benefits.[227] Government grants also have a role to play here as they can be directed towards projects with the highest social return. The problem with grants however is the government can't actually predict the social return and may end up 'picking losers'. Conversely, fiscal incentives are

[226] Newer economic models that focus on the cumulative nature of innovation are cautious about the link between patent strength and innovation. When one innovation builds on another innovation, a patent of excessive length or breadth can inhibit future innovation. However, a patent income exemption increases the economic benefit from a patent (and hence the underlying innovation) without increasing its length or breadth.

[227] The extent of the social benefits captured depends on the nature of the R&D and the length, breadth and strength of the patent.

a market-orientated response and thus are not prone to this problem. The differing pros and cons of these different supports illustrate that no one policy can be seen as the solution.

Industry Structure

5.7 In evaluating whether a patent income exemption is an appropriate policy response to the market failure it is noteworthy that the sectors that avail of patents the most, are the sectors where Ireland has or is attempting to build a significant economic presence. Nearly all technology fields experienced growth in patenting over the 1990s but Information and Communication Technology (ICT) and biotechnology in particular contributed disproportionately to the overall surge in patenting. Nearly half of the growth of patenting in the European Patent Office (EPO) in 1994-2001 is due to these two technology areas; patterns in the United States Patent & Trademark Office (USPTO) are similar (OECD, 2004).

5.8 This is important as it has been realised that in certain businesses informal methods of protecting intellectual property are more appropriate. Survey evidence for the USA suggests that, except in a small number of industries, patents are considered less effective than alternative mechanisms for protecting intellectual assets, such as, secrecy and lead time (Cohen, Nelson and Walsh, 2000). The exceptions are pharmaceuticals, chemicals, medical equipment and some machinery industries. Likewise, data for the UK shows that two of the three industry categories which place the most importance on formal intellectual property rights (IPR), include the manufacture of chemicals and the manufacture of electrical equipment (DTI, 2003).

5.9 Many of the industries quoted above, particularly Information and Communication Technology (ICT) and pharmaceuticals, are key sectors in Ireland, sectors where Ireland is trying to build research capabilities. The robust expansion of the Irish economy during the 1990s was largely driven by the strong performance of the industrial sector. Between 1995 and 2000, industrial output growth contributed around 52 per cent of total economic growth. Between them, the ICT sector and the pharmaceutical sector contributed around 90 per cent of total industrial output and employment growth between 1995 and 2000 (Central Bank Quarterly Bulletin, Autumn 2002).

FDI Perspective

5.10 Another important perspective from which to consider this policy is Ireland's reliance on foreign direct investment (FDI). Recent research by Lerner (NBER, 2002) found that patent applications by foreign entities were more responsive to protection enhancing patent policy changes, than were filings by domestic entities. Levels of innovation by foreign firms might not change but where they choose to seek patent protection it does. This is relevant to Ireland's patent income exemption as it shows that foreign firms may be responsive to different patent policies across countries, and in Ireland awarding of the exemption is dependent on some research activity being conducted in the country.

5.11 Another market failure pertinent here is the presence of a clustering externality. If the patent exemption encourages increased R&D activity (through new FDI or resident companies), then this increased R&D itself may encourage further R&D through industry clustering. Companies cluster together due to commonality factors such as the supply of skilled labour, input suppliers, specialised accountants, developed transport routes etc.

6. THE PRESENT USE OF THE PRE SCHEME

6.1 A formal cost benefit analysis of this scheme is not possible as the data available on patent income is very limited. Returns of income from patents are not recorded separately on Revenue's computer systems; instead they are aggregated with other forms of income. Thus a profile of the usage of the scheme is unavailable. Therefore the cost of the relief in terms of tax forgone and the R&D activities associated with the users of the scheme cannot be established.[228]

6.2 Following changes to the way information is entered on tax returns with effect from the tax year 2004, preliminary data for 2004 on patent income specifically will become available in early 2006[229]. Until then however, we can only investigate whether the data currently available indicates that the scheme is being used in accordance with its economic rationale outlined in the previous section.

Forfás Data

6.3 There does seem to be a pool of R&D active indigenous Irish companies availing of PRE. In a submission made to the Department of Enterprise, Trade & Employment, Forfás detailed the results of a survey conducted by them which identified 43 Irish firms availing of the Patent Royalty Exemption. The bulk of these firms operate in the Metals & Engineering and Internationally

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[228]Even if R&D data on the users of the scheme were available, it would be nearly impossible to calculate what percentage of the R&D was induced by the patent relief. This economic issue of deadweight involves separating out the contribution that this specific scheme has made to an increase in R&D being carried out in Ireland, as opposed to R&D that would have occurred anyway (deadweight). The main way deadweight is estimated is through surveys. However, these are nearly always prone to substantial bias due to the respondent's effect: the respondents to the survey have an incentive to exaggerate the importance of the exemption to ensure its continuance. On occasion, observation of the behaviour of the recipients of an exemption can lead to an estimation of deadweight. This can occur if another group can be found who only differ from the group under examination in one way, namely, through non-use of the exemption. This 'control group' can provide a 'counterfactual' scenario: what would have happened to the companies under examination if the exemption had not been in place. This information could then be used to estimate the impact of the exemption. However, this does not seem possible for this patent exemption scheme as any control group will differ from the companies using the patent exemption in many other ways such as scale, sector, position on the value chain etc. Furthermore, the very existence of the scheme could induce R&D activity that is unsuccessful, does not lead to a patent and the subsequent use of the PRE scheme. This R&D activity, induced by the patent exemption, would be included in the control group, affecting its independence from the patent exemption scheme.

[229] Income tax returns for 2004 can be filed up to 17 November 2005 at the latest. Following data input and processing, the data will become available from early 2006. Likewise in the case of corporation tax, returns for the year 2004 can be filed up to the end of 2005. Again after data entry and processing, the data will become available from early 2006.

Traded Services sectors. The individual firms confirmed R&D expenditure in 2003 of between €700,000 and €1.4 million (Metals & Engineering) and €330,000 and €1 million (Internationally Traded Services) respectively.

6.4 A survey 21 of Enterprise Ireland (EI) clients also confirmed 10 that currently benefit from the PRE scheme, each recording an average of over €200,000 of R&D expenditure per annum. This is twice the annual threshold used by Enterprise Ireland in defining "meaningful R&D" expenditure. It is thus clear that there are pools of indigenous firms spending multiples of this benchmark on R&D per annum which avail of the PRE scheme. Although it is not possible to exclude the role played by deadweight in this respect, the survey does confirm that a pool of indigenous firms are using the patent royalty exemption in a manner consistent with its R&D focused rationale.

6.5 Consultation with professional advisors suggests the use of the patent royalty exemption by the multinational sector to be far more confined.

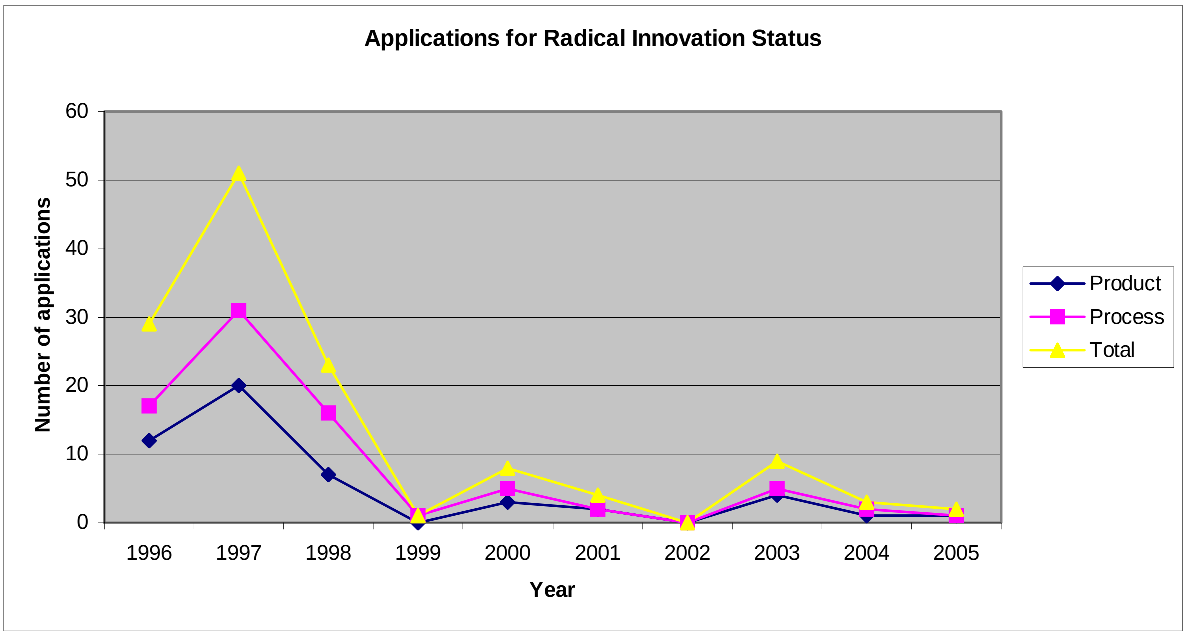
6.6 Data limitations prevent the grossing up from these examples to a macro picture of PRE usage. Nonetheless, the statistics outlined above show a significant number of R&D active companies who are using the scheme. Thus it is possible that any policy change based on the present level of information could negatively affect incentives for Irish industry to engage in R&D and for R&D active multinational firms to locate here.

Tax Avoidance Issues

6.7 The greatest potential for abuse of this scheme exists at the level of distributions to individuals, as they are exempt from tax at up to 42%, as opposed to retained profits from patent royalties that are exempt from corporation tax at 12.5%. As described in **Section 1** of this review, a restriction introduced in 1996 to combat tax avoidance required that distributions made from patent royalty income by a manufacturing company to a connected party should involve radical innovation in order to qualify for unlimited patent distributions. Otherwise distributions are limited to the company's aggregate expenditure on R&D incurred in that and the two previous accounting periods. Eighty such applications were made to Revenue between 1996-2005. The details are presented in the graph overleaf.

6.8 The sharp fall in the number of applications received in recent years may indicate that the anti-avoidance legislation has succeeded in curbing known abuses of the relief. Further analysis of the data shows that 46% of all applications were accepted of which 72% related to product and 28% to process innovations. Interestingly, 55% of all product applications were accepted, whereas only 31% of all process applications were accepted. As product innovations are generally deemed more likely to be genuine innovations this indicates that this test is working.

6.9 This does not however, ensure that there is no abuse of exempt distributions. An R&D cap applies where the radical innovation status is not awarded. Also where the R&D cap applies no specific avoidance test applies. The R&D however, does not have to be related to the relevant patent. The legislation currently merely confines the potential for abuse to companies that are R&D active and ensures that any such abuse is capped at a particular level. It would seem relatively easy, legislatively, to tighten up this area by applying the avoidance test generally.



6.10 The R&D cap and the radical innovation test only apply for payments between connected parties where the payer is a manufacturing company. There is no limit on distributions out of patent royalties paid in independent commercial transactions made at arm's length between unconnected parties.

6.11 At least one instance of an avoidance scheme in the latter area has come to light around the issue of franchising.

7. CONCLUSION

7.1 The absence of comprehensive data makes any cost benefit analysis of this incentive difficult. The evidence available is only partial and in many cases largely anecdotal. The scheme has a strong economic rationale and is in line with present government policy. Furthermore, many companies active in the R&D area are using the scheme. The 2004 tax returns information should provide a somewhat more comprehensive information base. This may enable meaningful data analysis once these are available from early 2006.

8. OPTIONS FOR AMENDMENTS TO THE SCHEME

8.1 The taxation system is one method of promoting R&D; it operates in conjunction with others, as outlined in Section 3. Further knowledge of this interaction is required in order to achieve the appropriate balance between grants, the R&D tax credit, the patent exemption and other possible policies. This knowledge is needed to contextualise the cost and value of the patent exemption.

8.2 Some possible amendments to the scheme are presented below dealing with data availability and the closing down of specific tax avoidance possibilities in the existing scheme which require immediate consideration.

8.3 Options for amendment

1. **Increase data availability, perhaps by the greater involvement of Forfás or other statistics agencies in data collection**.

2. **Strengthen the anti-avoidance measure in respect of distributions of exempt patent royalty income derived from manufacturing or deemed manufacturing where the payer of the royalty and the recipient company are connected**.

3. **Limit the re-characterising of certain payments as patent royalties to prevent tax avoidance**.

8.4 Other issues

Certain other issues came to light in the course of the review which will be considered in due course.

Appendix H.1:

PATENTS

INFORMATION BOOKLET

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1. What is a patent? _____ *H.22*

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INTRODUCTION

The information available in this booklet is not intended to be fully comprehensive, it is a general guide; it's not a legal interpretation of the law relating to Patents. Some Information may have changed since publication.

It summaries certain important provisions and requirements of the Patents Act, 1992, and the Patents Rules, 1992, in relation to obtaining of patents and briefly to European and International applications for patents.

It does not analyse every aspect of the patenting process or address particular legal provisions, which may affect a particular application. As with all guides it, of necessity, includes a number of generalisations and simplifications and should not be regarded as a substitute for the legislation itself.

The Patents Office cannot undertake to prepare a patent application on behalf of the applicant.

Patents Office staff cannot offer opinions or advice on such issues as the commercial value of inventions, nor can the Office give any financial assistance to inventors in the patenting or development of inventions.

Inventors should be aware that any public disclosure of an invention before an application for patent has been made might prejudice the obtaining of a valid patent.

1. What is a patent?

A patent confers upon its holder, for a limited period, the right to exclude others from exploiting (making, using, selling, importing) the patented invention, except with the consent of the owner of the patent.

A patent is a form of 'industrial property', which can be assigned, transferred, licensed or used by the owner.

Patents are territorial in effect e.g. an Irish patent is only valid in Ireland.

2. How long does a patent last?

Irish patents, in common with most jurisdictions, have a maximum life span of twenty years. Ireland also offers a “short-term” patent, valid for a maximum of ten years. To maintain a patent in force, annual renewal fees must be paid each year from the third year.

3. Why patent inventions?

Since a patent confers legal rights concerning the exploitation of an invention, it allows the owner the best opportunity to profit from the invention by preventing others from copying it. An inventor does not need a patent in order to exploit an invention; but without a patent the inventor would not be able to prevent others from copying the invention.

Inventors are often not in a position to produce or market their invention from their own resources. Patents, being a form of commercial property, provide a basis for owners to negotiate with potential investors or other business partners while preserving their intellectual property rights.

The prospect of gaining profits from this special form of protection serves to promote research activity and to give an incentive for new investment. Income derived from a patented invention developed in Ireland may be eligible for special favourable tax treatment.

4. What is patentable?

In order to be eligible for the grant of a valid patent the invention must be new, involve an inventive step and be capable of industrial application.

- Novelty: An invention is considered new if it does not form part of the state of the art. The state of the art comprises everything made available to the public in any way, anywhere in the world, before the date of filing of the patent application.
- Inventive step: An invention is considered as involving an inventive step if it is not obvious to a person skilled in that area of technology, having regard to the state of the art.
- Industrial applicability: The invention must be capable of being made or used in some kind of industry, including agriculture.

5. Excluded Subject Matter and exceptions to patentability

Not all inventions qualify for the grant of a patent. The Patents Act specifically excludes the following subjects from patentability:

(i) Discoveries and aesthetic creations:

(a) a discovery, a scientific theory or a mathematical method;
(b) an aesthetic creation;
(c) a scheme, rule or method for performing a mental act, playing a game or doing business, or a computer program; or
(d) the presentation of information.

Although such subject matter or activities are not patentable their use or application may be patentable. For example, a scheme or method for playing a game is not patentable, but it is possible to obtain patent protection for a novel apparatus for playing a game. Also, the exclusion from patentability of computer programs does not prevent the granting of patents for inventions involving the use of such programs, as long as a technical effect is achieved by its implementation.

Software

While it is not possible to obtain a patent on software *per se*, patents may be granted for inventions requiring the use of software to achieve their purpose. This, however, is conditional on the software having a “technical effect” when the programme is run. Such effect may, for example, be found in the control of an industrial process or in the internal functioning of the computer itself.

(ii) Methods of medical and veterinary treatments:

Methods of treatment of the human or animal body by surgery or therapy and diagnostic methods practised on the human or animal body are not patentable. This exclusion does not apply to products, substances or compositions for use in any of these methods, i.e. medicines or surgical instruments.

(iii) Plant and animal varieties or essentially biological processes for their production.

Plant varieties may be protected by other means, such as through the Office of the Controller of Plant Breeders Rights*. However if the invention concerns plants and animals and if the technical feasibility of the invention is not confined to a particular plant or animal variety, the invention may be patentable.

(iv) Inventions the publication or exploitation of which would be contrary to public order or morality.

This exclusion is subject to the proviso that the exploitation of such inventions is not deemed to be so contrary merely because it is prohibited in law.

*Footnote

Office of the Controller of Plant Breeders Rights
Department of Agriculture, Food and Rural Development
Backweston
Leixlip
Co. Kildare
Tel: 353 1 6280608

6. Types of Patents

There are two types of Irish patents available

(1) Full-term patents

These patents allow the inventor/applicant protection for up to 20 years. For a full-term patent to be granted, the applicant must provide evidence of the invention's novelty. This can be done by requesting a "Search Report" from the Office, or by submitting evidence of novelty. (Explained in more detail later in this booklet)

(2) Short-term patents:

Short-term patents are designed to assist smaller inventors. These patents can also suit inventions where a shorter market life is expected, or inventions that are not technologically complex.

These patents last for a maximum of ten years, and the applicant does not need to provide evidence of the invention's novelty. This effectively reduces the costs and length of time involved in getting an invention patented.

Because procedures are generally simpler, short-term patents can be granted reasonably quickly and well within 12 months from the filing date if requirements are complied with promptly. If applications are made for both a short-term patent and a full-term patent in respect of the same invention, the short-term patent will become void when the full-term patent is granted.

With some exceptions, the provisions relating to full-term patent applications and patents also apply to short-term patent applications and short-term patents. The main exceptions are:

(i) The specification of a short-term patent application must not include more than five claims. The requirements of novelty and industrial applicability apply but instead of non-obviousness, it is sufficient that the invention be "not clearly lacking an inventive step". Neither a Search Report nor evidence of novelty in the form of a foreign patent specification as discussed in paragraph (24) is required in order that a short-term patent be granted.

(ii) The filing fee, grant fee and renewal fees are only 50% of those for a full-term patent; and generally the procedures are simpler. This will be of particular interest to small enterprises and single inventors.

(iii) Infringement proceedings can be brought in the Circuit Court (or in the High Court, as is required for full-term patents) irrespective of the amount of a claim.

(iv) Before taking an action for infringement the owner of the short-term patent must either (a) request the Controller to have a Search Report prepared and send a copy of the report to the alleged infringer or (b) if a foreign Search Report or patent specification (as discussed in paragraph 24) is available, furnish copies of such reports to the Controller as well as the alleged infringer. The reports referred to a (a) or (b) are published by the controller

(v) a person other than the owner of the short-term patent whose legitimate business interests require a novelty search and who can show grounds for suspecting that the invention lacks novelty or is clearly lacking in inventive step may also request the Controller to have a Search Report prepared. Such a search report is published by the controller.

7 Supplementary Protection Certificate

A supplementary protection certificate (SPC) may be obtained in relation to individual medicinal and plant protection products disclosed in a patent. The certificate extends the protection conferred by the patent beyond its 20-year term for a period of up to five years.

Medicinal products, and many agricultural chemicals, require market authorisation before they can be sold commercially. Though this process is independent of the patent granting procedure, the owner of such inventions may find that though they have a patent for their product, they may still have to wait for a number of years before they obtain the necessary authorisation to market it. SPCs compensate the patentee for this loss of time, by extending the patent protection *for specific products* by up to five years.

An SPC does not extend the duration of the patent itself, but only the protection for the specific product subject to market authorisation.

8 Who may apply for a patent

Any person may make an application for a patent; the right to a patent belongs to the inventor or the inventors' successor in title. However, if an employee makes an invention in the course of his/her employment the right to the patent may belong to the employer. An application may be filed by joint applicants.

9 How to apply for a patent

A patent application consists of:

- a request for the grant of a patent (completing the application Form No.1 is sufficient to comply with this requirement).
- a specification containing a description of the invention, one or more claims defining the matter for which protection is sought and any drawings needed for the disclosure.
- an abstract containing a summary of the matter contained in the specification.

The application must be accompanied by the appropriate application fee.

10 Minimum requirement for a filing date

It is possible to secure a filing date without a fully completed patent application, as long as each of the following is submitted:

- A indication that a patent is sought
- Information identifying the applicant
- A description of the invention, and
- The prescribed fee

An application made in this manner will have to be followed by a formally completed application as indicated in paragraph 9 above and no additional subject matter should be added to the application beyond that contained in the original filing.

If a patent application does not comply with a requirement of the Act or the Rules the applicant is given an opportunity to meet that requirement within certain time limits e.g. a period of 12 months from the date of filing (or if priority has been claimed, from the date of priority) is prescribed for the filing of the claims and abstract.

The consequence of non-compliance with time limits is that the application may be refused or deemed withdrawn. Please note certain time limits are absolute.

11 Patent Agents

To be registered in the register of patent agents maintained by the Controller a person must possess the prescribed education and professional qualifications and satisfy certain other conditions. The Patents Office cannot advise applicants as to choice of agent, but the office does recommend the use of a patent agent. A list of registered patent agents is available on the Patents Office website (www.patentsoffice.ie) or on application from the Office.

Patent law and practice, and the drafting of the specification, describing an invention, are complex matters for which the help of a patent agent is very advisable unless the applicant has had specialised training in this field. The contents of the specification determine whether a patent can be granted as well as the scope and validity of the granted patent. The patent agent also arranges to file patent applications abroad and provides advice on matters relating to the commercial exploitation of an invention. The invention can be discussed freely with the patent agent because the disclosure will be in confidence.

Applicants and persons involved in proceedings before the controller having neither their residence nor principal place of business in the State are currently obliged to appoint a patent agent to act on their behalf. All applicants whether resident in the state or not are required to use the services of an agent in certain matters (following establishment of search reports or submission of evidence of novelty mainly.).

Where a patent agent is appointed by an applicant, all enquiries should be directed to that agent and all official communications from the Patents Office are with the appointed agent.

12 Format of a patent application

A patent application comprises a (Form No.1) a completed form entitled "Request for the Grant of a Patent "of Schedule II of the Patent Rules 1992 (Form No.1) and a specification.

13 The Specification

The specification should be in conformity with the requirements of the Patents Act 1992 and Patents Rules 1992, typed or printed on single sided A4 pages with margins of 2 to 3 centimetres. These margins should be blank, and each page should be numbered. **Two copies of the specification must be submitted.**

The specification provides the technical information about the invention, and provides its legal definition. It has four components, presented in the order in which they should occur in an application:

(1) The title,
(2) a description of the invention,
(3) claims, and
(4) drawings, if relevant to the application.

14 The Title

This comes first in the specification. It should be brief, but must clearly indicate the matter to which the invention relates. The same title should appear both on the specification and the request for grant form.

15 The Description

The description immediately follows the title. It is a detailed explanation of the invention. It should include all relevant information. It must be sufficiently clear and complete to be understood by others; such as to allow a person reasonably skilled in the same art to be able to fully replicate the invention without needing further details.

The description should set out the background of the invention and also explain any particular problem that the invention solves, and what it does.

Please note in particular that additional information cannot be added or the description broadened after you have filed the application.

A filing date cannot be secured in the absence of a description of the invention which is the subject of the request for grant of a patent.

16 The Claims

The claims, which follow the description, define the scope of the invention and the legal protection conferred by the patent when granted.

The claims must define the matter for which protection is sought in terms of its technical features. They must be clear and concise and be supported by the description.

There are two kinds of claim, independent and dependent. An independent claim defines an embodiment of an invention, comprising all its essential features. Dependent claims define further embodiments further characterised by desirable, but non-essential, features or components. These claims are dependent on the independent claim that gives the basic invention.

Claims must not speculate on the perceived advantages of the invention, but restrict themselves to embodiments and technical features. The advantages of the invention may be outlined in the description.

The specification may contain independent claims in different categories, e.g., for each of a product, the process for making that product, and specially adapted apparatus used in that process. However, all the independent claims must relate to the same basic inventive concept to ensure unity of invention.

If there are several claims, they should be numbered consecutively

If the claims are not filed with the application they **must** be filed within 12 months of the filing date or if priority has been claimed within 12 months of the priority date.

17 The Drawings

Drawings are not obligatory. However, a good drawing (or set of drawings) is often of great value in clarifying the nature of an invention. Therefore, drawings may accompany the specification. Where they do they must be mentioned in the text of the description. They must be clear and legible with no extraneous text. Drawings should be filed at the same time as the rest of the specification. Late filing of drawings has implications for the filing date of the application. Please note chemical formulae are normally included within the description.

18 The abstract

In addition to the specification, an applicant must also supply an abstract.
This is a concise summary of the invention. The abstract should be typed on a separate sheet of A4 paper and must begin with the title of the invention that appears

in the specification and the request for grant. It should include the essential features of the invention and should ideally be no longer than 150 words.
The abstract, like the claims, **must** be filed within 12 months of the application filing date(or priority date where claimed) if it has not been filed with the application. Abstracts are not part of the specification, and are not used to interpret the scope of protection sought. Rather, they provide a technical summary of the invention for archiving and retrieval purposes, thus assisting third parties in deciding whether the application as a whole might be of interest.

19 Scope of patent application.

Once the application has been filed, the specification may not be amended in any way that extends the scope of the subject matter. While it is possible to edit a specification - perhaps in the interests of better expressing something that is present from the start, or removing subject matter which the applicant no longer wishes to be part of the protected invention - anything that adds in a substantive way to the original filing will be refused.

To assist applicants in the process of drafting their patent specification, copies of sample specifications and abstracts from a range of technical disciplines are available from the Patents Office website (www.patentsoffice.ie).

20 Priority

If an application in respect of the same invention was filed up to 12 months earlier in either Ireland, the European Patent Office or a country that is a party to the Paris Convention for the Protection of Industrial Property, the filing date of the earlier application becomes the "priority date" of the new application.

This period of 12 months allows an applicant for a patent, having established a filing date for their invention in one jurisdiction, time to assess its commercial potential market, continue the development of the invention and to decide in which countries protection is to be sought without losing their priority right. If there has been more than one earlier filing (e.g. if an application has been made in the UK and Germany in respect of the same invention) this can give rise to more than one priority date in respect of a subsequent Irish application; however, time limits which are started to run from the date of priority run from the earliest of such priority dates.

The main effect of the priority right is that the filing date of the first application counts as the date from which the state of the art is assessed against the application and where 2 or persons make an invention independently, the right to a patent belongs to the person whose filing date or claimed priority date is the earliest.

21 Claim to priority

Any priority claim must be made in the request for grant (Form No. 1) indicating the date of filing, the country and filing number of the previous application. A certified copy of the previous application **must** also be supplied within 16 months of the earliest priority date, if it was a foreign application. This certified copy should be obtained from the Office abroad where this earlier application was made.

Where the claim to priority is based on an earlier Irish application, the applicant may, instead of submitting a certified copy, request that such a copy be included with their application. In this case the Patents Office will arrange for a copy of the earlier application to be associated with the new application, on payment of the prescribed fee.

Examination

If a patent application does not comply with a requirement of the Act or the Rules the applicant is given an opportunity to meet that requirement. When there are no outstanding requirements the applicant will be requested to pay the fee for the grant of a patent following which a certificate of grant is issued.

22 Divisional Patent Application

Applications disclosing more than one invention are said to lack "unity of invention". Where this happens, the applicant must remove all the subject matter that does not relate to the first invention. However, such subject matter may be "divided out" into new patent applications for each such invention. These "divisional applications" keep the filing date of the original application, but are otherwise examined as applications in their own right.

23 Patent pending

This is a term often used on products to alert competitors that an application has been made to protect the invention.

24 Search Report / Evidence of Novelty

For a Full-term patent to be granted, the novelty and non-obviousness of the invention must be established. There are two ways of achieving this; by means of a Search Report, or the provision of Evidence of Novelty.

Search Report

A Search report has to be requested by the applicant to determine the novelty and non-obviousness of the invention of the patent application. An applicant must request it within twenty-one months of the application's filing date or the priority date, if priority was claimed. Otherwise, the application will be refused. The Controller, upon receipt of this request accompanied by the prescribed fee, will have a Search Report on the invention prepared.

A Search Report will list published documents considered relevant in assessing whether the claimed invention is new and not an obvious development or adaptation of what is already known. A copy of the search report will be issued to the applicant.

Unless the patent application is withdrawn within two months of issue of the Report to the applicant, the report then published by the Controller; i.e. this means that anyone can view the search report. Withdrawal of the application might arise where the applicant, in the light of the Search Report, concluded that there was no point in taking the patent application further. If the patent application is not withdrawn the patent agent acting for the applicant will be required either to make amendments to the application based on the search report or provide a statement that no amendment is considered necessary. Failure to comply with these requirements may lead to the refusal of the application.

Evidence of Novelty

There is an alternative to requesting the preparation by the Controller of a Search Report. An applicant who has also applied for a patent for the same invention to the United Kingdom, German or European Patent Offices, or who has applied under the Patent Co-operation Treaty, can submit a statement to that effect; the statement **must** be submitted within the twenty-one months of the application's filing date or the priority date, claimed. In this situation, a copy of the Search Report prepared in respect of the foreign application, or a copy of the published specification of the patent granted by either the UK or German or the European Patent Office may be submitted to the Controller as evidence of Novelty and must be produced by the applicant within two months of the publication of the search report or grant of the patent, accompanied by the prescribed fee.

Evidence of Novelty will be published unless the application is withdrawn.

If the application is not withdrawn the patent agent acting for the applicant will be required either to amend the application in the light of the Search Report or the patent specification (whichever applies in the particular case) or to furnish a statement that no amendment is considered necessary. Failure to comply with this requirement may lead to the refusal of the application.

(The procedures relating to the search report/evidence of novelty do not apply to applications for short-term patents)

25 Publication of a patent

A patent application is published, i.e. certain documents relating to the application are open to public inspection, as soon as practicable after the expiry of a period of eighteen months from the filing date (or the priority date if there is one), unless it has been finally refused or withdrawn before the termination of the technical preparations for publication.

It may however be published earlier upon request by the applicant. The publication of an application is advertised in the Patents Office Journal.

Copies of published applications are available to anyone who wishes to inspect or purchase them.

26 The Patents Office Journal

The Office publishes the Patents Office Journal on a fortnightly basis, generally it's published on a Wednesday. The Journal is in two parts.

Part 1 concerns patents and designs and includes information under a number of headings, including,

- Patent applications filed
- Applications published
- Patents granted
- European Patents granted designating the State
- Applications lapsed
- Applications withdrawn, deemed withdrawn or refused.
- Patents expired
- Proceedings under the Patents Act, 1992
- Matters concerning Supplementary Protection Certificates.

Part II of the Journal contains information relating to trade marks

The Office provides an interactive, on-line version of the Journal, including search facilities.

Journals may be viewed online via the website or consulted on request at our offices in Kilkenny and Dublin or purchased directly from the Office or from the Government Publications Sales Office.

27 Protection of Patents abroad

If patent protection is required beyond the Irish jurisdiction, the following options are available:

- Application under the "European Patent Convention"
- Application under the "Patent Convention Treaty"
- Application made to each National Patent Office or Industrial property office of the country where protection is required.

28 European Patent Convention (EPC)

The European Patent Convention (EPC) was established in 1973 to strengthen co-operation between the States of Europe in respect of the protection of inventions, on the basis of the law established by the convention and the setting up of the European Patent Office in Munich for the grant of European patents in accordance with the law of the EPC.
Ireland became a member of the European patent organisation in August 1992 having acceded to the EPC

The EPO is not an institution of the European Union. It is a separate international organisation with its own administration and headquarters in Munich.

The main advantage and purpose of the EPC is that it allows patent rights to be obtained in any one or more of the EPC contracting states by making a single European patent application to the European Patent Office. This may be considerably cheaper than making a separate 'national' application in each EPC member.

On the basis of a single patent application the EPO grants, in effect, a "bundle" of national patents in respect of those contracting States, which the applicant designates. There are 30 contracting states as of 30 December 2004. While the application is pending, renewal fees are payable to the EPO. Once the patent is granted, renewal fees must be paid to the Patent Offices of each of the designated countries.

When granted, a European Patent has the effect of a national patent in each of the countries designated. A European Patent designating Ireland has the same effect as if it were a full-term patent granted by the Controller.

European patent applications may be filed either with the Patents Office in Ireland or direct to the European Patent Office.

The Patents Office transmits any application received to the EPO it is not required to carry out any examination on the application before transmittal. The Office does not require payment of a transmittal fee. An applicant must transmit all relevant fees to the EPO directly.

A European application may claim the priority date of an Irish application filed up to twelve months earlier. The European application is published 18 months after the filing (or priority) date. The EPO carries out a novelty search and the search report is published either with the application or later on. The applicant then has the possibility to decide whether or not to pursue his/her application by requesting substantive examination. If the request for examination is filed the specification is examined in detail by an Examining Division in the EPO to see whether the application meets all the requirements. After this examination the European Patent is granted and the patent specification is published.

Within 9 months after the grant of the European Patent, any person may give notice to the EPO of opposition to the patent granted. The decision of the EPO whether the patent is to be maintained, amended or revoked holds good in all the countries designated.

When a European Patent designating Ireland is granted, the relevant particulars are transferred to the Patents Office by the EPO. If the European patent specification is not filed in English (applications for European patents must be either in English, French or German), then a translation into English must be filed accompanied by the prescribed fee, with the Patent Office within six months of the date of grant of the European Patent. The patent is not considered to have had legal force in Ireland if this translation is not filed, and the patent is deemed void.

The Controller is empowered to revoke a patent granted under the Patents Act if it appears to him that a European Patent designating Ireland has also been granted in respect of the same invention, if both applications have the same filing or priority date and were filed by the same applicant.

It is possible to file a European Patent application electronically with the EPO.

For further information, contact:

European Patent Office,
Erhardstrasse 27,
D-8000, Munchen 2
Germany
Website: www.european-patent-office.org

The following brochures are also available from either the EPO or the Patents Office:
“How to get a European Patent (Guide for applicants)”
“National Law relating to the EPC”

29 Patent Co-operation Treaty (PCT)

The Patent Co-operation Treaty (PCT) was established in 1970. It is administered by the International Bureau of the World Intellectual Property Organisation (WIPO) in Geneva. Ireland ratified the Treaty in 1992.

The main objective of the Treaty is the streamlining of patent application filing and novelty search procedures for applicants wishing to obtain patent protection in a wide number of countries around the world.

The PCT provides a system whereby a single international application allows for the designation of some or all the contracting countries. The relevant national patent authority is normally the granter of a patent pursuant to an application filed under the treaty.

A PCT application requesting patent protection in Ireland is deemed to be an application for a European patent for Ireland and will be processed by the EPO in accordance with the EPC (European Patent Convention).

An application for an Irish patent under the Patents Act, 1992, can be used as a basis for claiming 'priority' for applications filed under the PCT, provided that these filings are within 12 months of the date of filing of the earlier Irish application for the same invention.

The Patents Office acts as a receiving office for PCT applications of nationals or residents. The Office carries out an administrative formalities check before transmitting the application to the International Bureau. The Office accepts certain fees associated with an International PCT application for transmission to WIPO.

It is also possible to file a PCT application electronically using WIPO's electronic filing software PCT-SAFE.

Additional information on the operation of the PCT is available from:

- WIPO website: www.wipo.org
- E-mail: pct.infoline@wipo.int
- World Intellectual Property Organisation,
  34 Chemin des Colombettes,
  1211, Geneva 20
  Switzerland.
  Tel: 0041 223389352

The following brochures are also available from WIPO:
"Basic Facts about the PCT"
"PCT Applicant's Guide"

30 Application to other countries, made to the relevant National Patent Office or Industrial Property Office.

There is no such thing as a "World-Wide Patent". To obtain patent protection in other countries it is necessary to pursue an application for a national patent in each country which you require a patent unless the options offered by the EPC or the PCT routes are availed of.

The Office website provides links to many other Patent Offices and Industrial Property Office websites where you may obtain further information relating to the application procedures in these countries.

31 Patent Searching

The function of patents is twofold, to provide protection for inventions, and to ensure dissemination of technological information to the public. This dissemination of information is all the more important when it is considered that patent literature alone accounts for over 80% of all published technical knowledge.

(i). Patents Office online register and database search system.

In 2003 the Patents Office launched its online register and database search, which permits free and unlimited access to the Office's patent register and databases.

The system enables access to the Patent Register and Databases, which contain detailed information about specific published patents, and the Supplementary Protection Certificate (SPC) Database, which relates specifically to SPC applications.

The system, allows users to find and browse particular entries with a minimum of effort. The online registers and databases are updated on a daily basis, and therefore enable web access to an extensive repository of data concerning patent~~s~~. The search system also features navigational aids and help menus for user guidance.

The system also provides convenient links to various International IP offices such as the European Patent Office (EPO) and the World Intellectual Property Organisation (WIPO). These links facilitate free online access to over 45 million patent documents, the largest volume of patent documentation available on the Internet.

Whilst the Office has taken great care and pursued all reasonable steps to ensure the accuracy and integrity of the data contained in the search system, it should be born in mind that this facility is essentially for general information purposes only. It should therefore not be relied upon as a stand-alone tool or regarded as a complete and comprehensive search system. Users are advised that, business decisions should not be made on the basis of these searches alone.

(ii). ESP@CENET

To further promote the free availability of patent information, the European Patent Office (EPO), the member states of the European Patent Organisation and the European Commission combined to launch the esp@cenet service in 1998. esp@cenet is designed primarily for the general public and its main aim is to provide non-specialist users with a readily accessible source of free patent information published by patent offices around the world, in some cases dating back to 1920. Specifically, espa@cenet offers access to:

- Published patent applications of the EPO member states (including Ireland).
- EPO published patent applications.
- Published PCT (Patent Co-operation Treaty) applications from the World Intellectual Property Organisation (WIPO).
- "Worldwide" patent information (English language patent abstracts).
- Japanese patent documents.

It should be noted that a search carried out in the esp@cenet database cannot replace a professional search. The information furnished is indicative of published patents but is not exhaustive and the service cannot be considered as a complete and only source of patent information.

32 Patent Costs

Patenting costs can vary substantially. Factors such as the type of patent desired (e.g. a short-term patent or a full term patent) and whether protection in Ireland or abroad is sought, are relevant.

In addition to the statutory fees charged by national patent offices, applicants will need to bear in mind the costs of engaging the services of patent agents, which again can vary depending on the extent of the advice and assistance sought.

There can be other statutory fees payable depending on such factors as the need to amend applications or extensions of time requirements. In addition, annual patent renewal fees must be paid from the third year in order to keep a patent in force.

Details of the statutory fees are available on the website or from the Patents Office.

Enterprise Ireland Inventions Assistance Scheme

General advice and information on the protection, technical development and commercialisation of inventions is available from Enterprise Ireland under the Intellectual Property Assistance scheme.

In appropriate cases, Enterprise Ireland can provide financial assistance.

For further information contact:

Enterprise Ireland Intellectual property Unit
Enterprise Ireland
Glasnevin
Dublin 9

Website: www.enterprise-ireland.com

Tel: 01- 8082000

Patent Information on the Internet

www.patentsoffice.ie	Irish Patents Office
www.patent.gov.uk	UK Patent Office
www.wipo.org/index.html.en	WIPO
www.bie.nl/engels/index.htm	Netherlands Patents Office– PION search engine (Registration required)
www.uspto.gov/patft/index.html	US Patent Office searchable database
www.european-patent-office.org	European Patent Office

The 'Links' section of the European Patent Office website contains lists of other commercial information service providers, resources and Patent Attorneys. It also has a link to the EPO 'ESPACENET' search engine.

www.derwent.co.uk	A commercial provider of Patent Searching and information
www.micropat.com	A commercial provider of Patent Searching and information
www.delphion.com	A commercial patent search engine
www.optics.org/research/patents.cfm	Search IBMs Patent and Trade Mark database.
www.strategis.gc.ca	Canadian Intellectual Property Office
www.ipaustralia.gov.au	IP Australia

Completing a Request for the Grant of a Patent (Form No.1)

The applicant should indicate the type of patent requested

The applicant should fill in his/her name and address.

Applicant's nationality
(for statistical purposes)

The title of the invention should be brief and indicate the matter to which the invention relates.

If priority is being claimed on a previously filed patent application (this application must not be more than one year old), its details must be filled in here.

Insert here the name and address of the person(s) believed to be the Inventors of the invention.

FORM NO. 1.

REQUEST FOR THE GRANT OF A PATENT

PATENTS ACT, 1992

The Applicant(s) named herein hereby requests

☐ the grant of a patent under Part II of the Act

☐ the grant of a short-term patent under Part III of the Act

on the basis of the information furnished hereunder.

1. Applicant(s)

Name

Address

Description/Nationality

2. Title of Invention

3. Declaration of Priority on basis of previously filed application(s) for same invention (Sections 25 & 26)

Previous filing date	Country in or for which filed	Filing No.

4. Identification of Inventor(s)

Address

CONTINUED OVER

The applicant should indicate the items accompanying the request form including the prescribed filing fee.

If the current patent application is a divisional of a previous patent application, then details of the earlier application number and its filing date must be given

If the applicant has retained the services of a patent agent, then the details should be inserted here.

If an agent has been appointed then this will be taken as the address for all correspondence. If no agent has been appointed then the address (within Ireland) for all correspondence should be completed.

The application form must be signed and dated by the applicant or the agent appointed to act on their behalf.

5. Statement of right to be granted a patent (Section 17(2)(b)

6. Items accompanying this Request – tick as appropriate

(i) ☐ Prescribed filing fee (€)

(ii) ☐ Specification containing a description and claims

☐ Specification containing a description only

☐ Drawings referred to in descriptions or claims

(iii) ☐ An abstract

(iv) ☐ Copy of previous application(s) whose priority is claimed

(v) ☐ Translation of previous application whose priority is claimed

(vi) ☐ Authorisation of agent (this may be given at 8 below if this Request is signed by the Applicant(s))

7. Divisional Application(s)

The following information is applicable to the present application which is made under Section 24 –

Earlier Application No:………………..

Filing Date: ………………...

8. Agent

The following is authorised to act as agent in all proceedings connected with the obtaining of a patent to which this request relates and in relation to any patent granted –

Name **Address**

9. Address for Service (if different from that at 8)

Signed Name(s):

Capacity (if applicant is a body corporate):

Date

The Patents Office may be contacted at:

Patents Office
Government Buildings
Hebron Road
Kilkenny

Tel.: 056 –7720111
Lo-call 1890-220223 (within Ireland)
Fax: 056 – 7720100
Lo-call fax 1890-220120 (within Ireland)

E- mail: patlib@entemp.ie

The Patents Office also has an Information Office in Dublin located at:

Ground Floor,
The Earlsfort Centre,
Lower Hatch Street,
Dublin 2.
Tel: 01-6312121
Lo-Call: 1890-220222
Fax: 01- 6312551

E-Mail: patdub@entemp.ie

Patents Office website: www.patentsoffice.ie

The Patents Office is open to the Public from 9.45 am to 4.15 pm including lunchtime.

<u>Appendix H.2:</u>

Summary of submissions received

Institute of Chartered Accountants in Ireland

The Institute of Chartered Accountants in Ireland submit that the patent income exemption forms an integral part of a package of measures operating in Ireland to stimulate R&D activities and that it is achieving its original intent. The evidence is that while Ireland is making progress in this area, international competition is increasing. They point to the use of R&D tax incentives in other EU countries and outside the EU (US, Canada, Australia, Japan and Puerto Rico in particular).

The recent Forfás report on Business Expenditure on R&D (the 'BERD' survey) identified annual growth between 2001 and 2003 amounting to 5.2%. They suggest that some of this growth at least can perhaps be attributed to the impact of the patent royalty scheme as an R&D incentive. They submit that modifications to the scheme could send a signal of instability in the tax environment for R&D, which of itself could be far more harmful than the mere removal of the tax incentive.

Industry Research and Development Group (IRDG)

This group is a non-profit independent representative group for manufacturing and international traded services companies in Ireland who are engaged in product and process R&D. Its client base consists of 400 companies and account for 60% of industry R&D expenditure in Ireland.

The Group's submission argues that Ireland's favourable company tax regime can to some extent be a disincentive to undertaking R&D here because it may be more attractive to write R&D cost in a high tax regime. The combination of supports Ireland offers of grants, the R&D tax credit and the patent income exemption scheme offset this fact to a considerable degree. They wrote that the first two supports apply to the company undertaking the R&D while the PRE acts in a complementary fashion as it applies to the individuals involved in the innovative R&D. The group would view the abolition of the scheme with considerable alarm.

American Chamber of Commerce

The American Chamber of Commerce *inter alia* represents the views of branches and subsidiaries of US corporations doing business in Ireland.

They are strongly of the view that its availability as an exemption from corporation tax should be preserved. The patent royalty exemption is considered another attraction for development for Ireland as a centre of knowledge and research and development, which will be used once significant R&D becomes widespread in Ireland.

Adverse change in this area is of a major concern at this particular time for several of the members whose parent companies are considering embarking on a number of R&D initiatives at plant and University level in Ireland.

Major US Company

One major US company indicated that it is strongly of the view that this exemption should be preserved to promote and foster the on-going use of Ireland as a viable location for value added R&D activity.

<u>Appendix H.3:</u>

Submission made by Forfas

Review of the Patent Royalty Exemption Tax Incentive

In the context of the review of the Patent Royalty Exemption undertaken by the Department of Finance during 2005, Forfás undertook a broadly targeted consultation with key enterprise stakeholders. This consultation sought to ascertain two things:

- A quantification of the use of the exemption amongst clients of the enterprise development agencies
- An assessment of the importance of the exemption as an incentive to the conduct of R&D activities leading to patentable outputs in this country

Due to very low levels of response from the survey cohort, and in the absence of any detailed information available through the Office of the Revenue Commissioners regarding draw down against this incentive, it was not possible for Forfás to establish a robust empirical assessment of the use of the incentive amongst the clients of the enterprise development agencies. However, enterprise feedback did confirm:

- good levels of awareness of the existence of the incentive
- relevance of the incentive to Inventor Entrepreneurs, Third Level Researchers, Existing Manufacturing Companies and Investors, (each of whom may access the incentive to differing extents and under variable eligibility criteria). Each of these categories would be seen as important contributors to supporting the increase of R&D activities amongst firms in Ireland
- evidence to support the thesis that the Irish Patent Royalty incentive is far more widely used among smaller, indigenous firms than in the multinational sector, albeit with a small number of high profile exceptions. This is an important distinction to recognise given the national enterprise policy focus on stimulating ongoing research in smaller firms as a driver of their overall competitiveness and productivity.
- emphasis on the potential importance of the incentive to innovative businesses, and
- a desire to see the exemption remain in place as one of the suite of incentives currently in place to promote R&D activities generally amongst firms in Ireland.

Forfás, in its submission to its parent department (the Department of Enterprise, Trade and Employment) concluded as follows:

1) In light of the incomplete data currently available to facilitate a robust cost:benefit analysis of the exemption, it would be inappropriate at this time to abolish or substantially limit the scope of the Patent Royalty Exemption in its present form.

2) To address concerns around the exploitation of the scheme for research developments lacking substance and not meeting an appropriate standard of

technological innovation, one proposal might be to add to the existing qualifying criteria a further requirement that in the case of claimants under Short Term Patents, these patents must be supported by at least one search validated by the Patents Office to support the innovative nature of the underlying patent.

3) On availability of detailed data regarding the utilization of the incentive which should be identifiable from 2004 tax returns, a comprehensive cost:benefit assessment should be undertaken, leading to a definitive view as to the future of this incentive.

INTERNAL REVIEW OF CERTAIN TAX SCHEMES

Section I:

Tonnage Tax Scheme
– Sections 697A - 697Q of the Taxes Consolidation Act 1997

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REVIEW OF TONNAGE TAX

1. EXECUTIVE SUMMARY

Summary of Findings

1.1 The Review's findings and conclusions are set out in shaded boxes throughout the various sections of the review but for convenience the most important are listed below.

- The primary objective of introducing tonnage tax has been achieved, namely, the retention in the State of the operational base of the main Irish shipping companies **(paragraph 6.8)**.
- Having regard to the findings generally in **section 6** of this review, the deadweight involved in the tonnage tax scheme is minimal and there is no evidence of displacement **(paragraph 6.11).**
- Tonnage tax cannot be used by high earners as part of a suite of tax reliefs and exemptions to reduce their tax liabilities significantly. **(paragraph 6.12)**.
- Tonnage tax seems to have been responsible already for between a 48% and a 68% increase in the Irish registered tonnage depending on the estimation method used **(paragraph 6.2)**.
- Having regard to the rates tonnage tax is levelled at it is virtually a tax exemption for shipping companies as respects their shipping income **(paragraph 6.4)**.
- Having regard to the decision of the main shipping companies to retain their base of operations in Ireland and the increase in the registered Irish tonnage, it can be argued, albeit anecdotally, that tonnage tax is not a cost to the Exchequer **(paragraphs 6.6)**.
- While the legislation specifically excludes from tonnage tax vessels whose primary use is for sports or recreational purposes, there may be a case for tightening-up and placing on a statutory basis the rules allowing genuine cruise ships into, and keeping pure recreational vessels out of, tonnage tax. **(paragraph 7.3)**.
- Initial indications are that the scheme is working as intended. The scheme does contain a number of anti-avoidance measures but abuses could still arise. A final assessment of this will have to await a Revenue audit of a tonnage tax company **(section 7.6)**.
- The agency responsible for the development of the shipping sector is of the view that the scheme has achieved its principal objectives and has also lead to considerable additional investment, employment and other activity in the Irish shipping industry and related sectors **(paragraphs 8.1)**.

- The liberalisation of the EU State Aid rules mean that Ireland can review the requirement limiting to 75% the ships operated by a company in tonnage tax that can be chartered-in **(paragraph 9.5)**.

List of Recommendations

1.2 The recommendations derive directly from the Review's findings and conclusions and are as follows:

- Tonnage tax should be retained as part of the State's support to the shipping sector, with the adjustments as set out in the recommendations following.
- The legislation should be amended to empower Revenue to require information on the structure and organisation of applicant companies; the beneficial ownership of the shares in such companies; ship registration and financing details; details as to actual and future employment and identification of personnel; copies of business plans; and any other information considered necessary to allow Revenue arrive at a considered opinion as to the bona-fides of a company.
- The legislation should be amended to provide a formal application process, including provision for prescribing forms, elections, etc. In addition, Revenue should consider publishing guidelines on the details to be submitted with applications including setting out likely timeframes for dealing with applications where all information requested has been supplied in a satisfactory manner.
- Companies should not be required to provide duplicate tax computation, one using the tonnage tax rules and another using normal corporation tax rules.
- As an alternative to providing duplicate tax computations, companies in the scheme could be required to provide the Department of Communications, Marine and Natural Resources with sufficient up-to-date economic and commercial information to enable policy makers to access the costs/benefits of the scheme to the Irish shipping sector and the economy generally in terms of the development and health of the sector (e.g. number and tonnage of ships, employment and additional economic activity in the sector - both on board and ashore) using the state of the industry at the time of the introduction of tonnage tax as a base line.
- The legislation should be amended to ensure that the statutory prohibition on purely recreational craft accessing the scheme is as robust as possible.
- The legislation should be changed to remove the requirement limiting to 75% the tonnage of ships operated by a company that can be chartered-in.

2. BACKGROUND TO THE REVIEW

2.1 In his Budget Statement of 1 December 2004 the Minister for Finance, Mr. Brian Cowen, T.D., announced that the Department of Finance and the Revenue Commissioners would, during the course of 2005, undertake a detailed review of certain tax incentive schemes and exemptions in the context of high-earners.

2.2 The initial focus of this review was the examination of area-based and sectoral-based property reliefs. Two separate consultancies were recruited to examine each of these areas. In addition, in-house reviews were started on various other exemption and relief schemes. Initially, a review of tonnage tax was not included in the review. The primary reason for this was because of the newness of the regime (introduced in 2002) and the fact that as a corporate relief it was not apparent how it could be used by high-income individuals to substantially reduce their tax liabilities.

2.3 However, as a result of questions raised in the Dail in June 2005, the Minister for Finance indicated that he would arrange for tonnage tax to be included in the review.

3. BACKGROUND TO TONNAGE TAX

Why an Irish Tonnage Tax?

3.1 In terms of developing the maritime transport industry, a tonnage tax was identified in the 2000 Irish Marine Development Organisation (IMDO)[230] Advisory Group report *"Turning of the Tide"* as a cornerstone to enable the development of the industry. Subsequently the recommendations in this report were put in 2000 to the Department of Communications, Marine and Natural Resources and the Department of Finance and again in September 2001 with the circulation of the IMDO report *"A Tonnage-Based Corporation Tax for the Irish Industry"*.

[230] The IMDO is the body charged with the promotion and development of the Irish shipping industry.

3.2 Tonnage tax was introduced in the 2002 Finance Act. The tonnage tax profit is calculated on the basis of a notional daily profit per ship based on a sliding tariff by reference to the net tonnage of the ship. This notional profit per ship is then multiplied by the number of days the ship was operated in the accounting period by the company to get the profit per ship for each accounting period. The profit per ship is aggregated to get the company's overall tonnage tax profits for the accounting period. The 12.5% corporation tax rate is then applied to this profit instead of being applied to the company's relevant shipping profits.[231]

3.3 Three main reasons leading to the decision to introduce a tonnage tax in Ireland can be identified. These were-

- Primarily to allow Irish-based companies to compete with EU competitors benefiting from tonnage taxes and additional tax and social security incentives in their own jurisdictions.

- Tonnage Tax regimes were also being encouraged at EU level in order that European member states could compete for maritime transport business being lost to extra-EU states and offshore tax havens.

- Other drivers for the introduction of tonnage tax included developing the maritime transport industry in Ireland, facilitating the growth of the indigenous sector and attracting interest from foreign direct investors.

3.4 At the time of the decision to introduce tonnage tax, Ireland's principal shipping companies indicated at the time that for commercial reasons they would have no option but to "flag" out their ships to jurisdictions with a tonnage tax regime if Ireland failed to introduce such a regime[232].

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[231] Section 697C TCA 1997 sets out the rules for the calculation of the tonnage tax profits of a tonnage tax company.
[232] Both groups have since entered the Irish tonnage tax regime.

Benefits of a Tonnage Tax

3.5 The purpose of a tonnage tax is not solely to provide a tax incentive for shipping. The intention behind tonnage tax is also to provide a number of real advantages for all shipping companies that enter the regime. These include-

- ***Certainty***, since the level of tax is known and minimal. This reduces the need for a company to make provision in its accounts for deferred taxation, thereby increasing earnings per share.

- ***Flexibility***, since companies have more freedom to choose when to buy ships and how to finance them. These decisions will now largely be determined by commercial rather than tax considerations.

- ***Clarity***, a company's tax position is more readily understood. Consequently the company may become more attractive to investors and potential business partners.

- Finally, ***compatibility and competitiveness*** with the fiscal regimes of other countries. This is particularly important from the point of view of maintaining and developing Ireland's indigenous shipping industry.

The EU Dimension

3.6 In the period from 1975 to 1995, most EU member states experienced a decline in the number of vessels registered under their home flags. This amounted to an EU wide 50% decline in the period (source: IMDO). The decline in the EU wide registered fleet was coupled with a severe decline in EU registered seafarers (both officers and deck crew). A similar decline in seafarers took place in Ireland. Apart from the loss of vessels and the decline in EU seafarers, it was also clear that flagging out of vessels tended to be followed by corporate relocation. This, in turn, led to the relocation of ancillary services as well as the personnel expertise in areas such as ship management, technical expertise, legal and banking.

3.7 The EU Commission recognised that urgent action was needed in order to halt and reverse the decline. In March 1996 the EU Commission set out its plans in this context in its communiqué *"Towards a New Maritime Strategy"*. In July 1997 the European Commission published Commission communication (97/C 205/05) – *Community guidelines on State aid to maritime transport*[233]. As part of the guidelines, the Commission took the significant step of introducing measures such as "a reduction to zero of taxation and social charges for seafarers and corporate taxation of shipping activities is the maximum aid which may be permitted". The Commission stressed the necessity of support measures for EU shipping to remedy the disadvantages that the EU shipping sector was facing. The guidelines are intended to support the Community's maritime interest.

3.8 The general objectives set out in the Guidelines were to:

- Safeguard EU employment (both on board and ashore).
- Preserve maritime know-how in the community and to develop maritime skills.
- Improve safety in EU registered fleets.

3.9 In order to achieve these objectives, the EU Commission approved the following specific measures:

- Fiscal treatment of ship-owning companies: Tonnage Tax Regimes.
- Labour related costs: Social Insurance/Income tax refunds/ exemptions.
- Training: Grant Aid.

3.10 **Appendix I.2** sets out the current position as respects "tonnage tax" type shipping taxation regimes in EU (including EEA) member States. **Appendix I.3** provides a broad comparison of the Irish tonnage tax regime with those in other EU countries[234].

[233] OJ C205, 5.7.1997, p. 5.
[234] Source: IMDO

Budget 2002 Announcement of Tonnage Tax

3.11 In his Budget 2002 Statement made on 5 December 2001 the then Minister for Finance, Mr. Charlie McCreevy, announced that he would introduce "a special shipping tonnage tax regime from 1 January next [i.e. 1 January 2002] in recognition of the particular requirements of the shipping industry."

4. DESCRIPTION OF TONNAGE TAX

Introduction

4.1 Tonnage tax is not a separate tax. Instead, it provides an alternative (or notional) method for calculating the shipping related profits of a company for corporation tax purposes. As such it forms part of the Corporation Tax Acts and was introduced into our corporate taxation regime as Part 24A of, and Schedule 18B to, the Taxes Consolidation Act 1997[235].

4.2 The measure did not come into immediate effect as it was subject to "state aid" approval by the European Commission. Following discussions with the EU Commission the scheme was approved by the EU Commission[236] from a state aid perspective subject to certain changes being introduced in the Finance Bill 2003. Following enactment of these undertakings in the Finance Act 2003 the scheme took effect from the date of passing of the Finance Act 2003 (i.e. 28 March 2003). In accordance with the Minister's original Budget announcement the legislation was framed in such a way that it could apply to the shipping profits of companies electing into the regime where those profits arose on or after 1 January 2002.

4.3 The term "Tonnage Tax" while standard in the various countries that have introduced similar measures is something of a misnomer. Tonnage tax is not itself a tax, rather it is an alternative method by which shipping companies may calculate their shipping related profits for corporation tax

[235] Inserted by section 53(1) of the Finance Act 2002 and subsequently amended by section 62 of the Finance Act 2003.
[236] 11 December 2002.

purposes. The shipping related profits once calculated using the tonnage tax method are subject to the 12.5 per cent rate of corporation tax. The profits are calculated by reference to the tonnage of the ships used in a company's shipping trade and hence the title[237]. Essentially, the "tonnage" profits replace for tax purposes the income and gains arising to a shipping company from certain very specific activities[238].

How Companies Qualify for Tonnage Tax

4.4 The tonnage tax scheme is elective, "qualifying companies"[239] may choose whether to stay in the normal corporation tax system or move their shipping activities into tonnage tax. If a company enters tonnage tax it must stay in it for a minimum of 10 years. The commitment to stay in for 10 years can be renewed by election (called a "renewal election") at any time in which case the period of the election is extended for a further period of 10 years from the date of this renewal election. Companies have a period of 3 years beginning from 28 March 2003 within which to make up their minds whether they want to enter the scheme. A decision-making period is standard in EU tonnage tax regimes and is designed to allow companies time to organise their businesses into tonnage tax and non-tonnage tax operations.

4.5 If a company becomes a qualifying company[240] after the expiry of the initial 3-year period and it was not previously a qualifying company, the company may elect for tonnage tax within a 3-year period of first becoming a qualifying company.

4.6 An election for tonnage tax takes effect from the beginning of the accounting period in which it is made. The legislation gives Revenue the authority to allow in exceptional circumstances (for example, the need to complete re-structuring to enable the legislation to actually apply to the business) an election to take effect from an earlier or later accounting

[237] Section 697C Taxes Consolidation Act 1997 provides the rules for the calculation of tonnage tax profits.
[238] The definition of "relevant shipping income" and "relevant shipping profits" in section 697A(1) Taxes Consolidation Act 1997 set out the income and gains sheltered by the tonnage tax calculation.
[239] See **paragraph 4.8** below for details.
[240] For example, a foreign shipping group deciding to set up an Irish based shipping subsidiary or an Irish group deciding to enter the shipping business for the first time.

period than the period in which the election is made. However, this discretion is subject to the overriding rule that no election can apply for any accounting period beginning before 1 January 2002 (this reflects the Minister's original Budget announcement that tonnage tax would apply with effect from 1 January 2002).

4.7 All qualifying companies in a group must enter the scheme. Cherry picking is not an option.

4.8 A "qualifying company"[241] must meet all 3 of the following tests:

- It must be within the charge to Irish corporation tax.
- The company must operate "qualifying ships"[242].
- In order to satisfy the EU requirement that a beneficiary from State Aid should have its strategic and commercial management in a EU State, the company must carry on the strategic and commercial management of the qualifying ships in Ireland.

Strategic and Commercial Management

4.9 The legislation does not define "strategic and commercial management". The reason for this was to avoid being too prescriptive as a wide variety of activities can be encompassed in the term "strategic and commercial"[243]. In administering the scheme the Revenue Commissioners require a company to demonstrate that all elements of management activity relevant to the ships in question takes place in the State in determining whether strategic and commercial management is carried out in the State.

Strategic Management

4.10 In the case of strategic management it would be expected that all decisions by the company on the following matters would be taken in Ireland:

- Significant capital expenditure and disposals.

[241] See section 697A Taxes Consolidation Act 1997.
[242] See section 697A Taxes Consolidation Act 1997.
[243] The equivalent UK scheme also avoids statutory definitions of these terms.

- The award of major contracts.
- Agreements on strategic alliances.

Other aspects of the company's business or physical presence that would be expected to find either carried out or located in Ireland in the context of strategic management include:

- The company's headquarters, including the principal seat of senior management staff.
- Decision-making of the company board of directors.
- Decision making of the operational board.
- The extent to which foreign based personnel work under the direction of, and report to, personnel based in Ireland.

Commercial Management

4.11 In considering whether a company's commercial management takes place in Ireland, the following tasks would be expected to be carried out in Ireland (this is not necessarily an exhaustive list):

- Route planning.
- Taking of bookings for cargo or passengers.
- Managing the bunkers, provisioning and victualling requirements.
- Personnel management.
- Training.
- Technical management including decisions on the repair and maintenance of vessels.
- Extent to which any foreign offices/branches work under the direction of Irish based personnel.
- Support facilities in Ireland.

4.12 It should be emphasized that the company must satisfy both aspects of the "strategic and commercial" test before it can be considered eligible for inclusion in the tonnage tax regime. In this connection, Revenue would generally require a detailed submission from the applicant company specifying how, exactly, the company intends to meet the requirements of the "strategic and commercial" test as outlined above. As part of this submission Revenue would generally expect that a copy of the company's business plans would be supplied.

Informational Deficiencies

4.13 As part of the assessment of the bona fides of any claim that a company's centre of strategic and commercial management is to be in Ireland, Revenue also requires certain information in respect of the background to, and origins of, the company. This includes information on:

- Names and addresses of directors.
- Names and addresses of shareholders specifying shareholding in the company.
- Details on the ships the company owns such as registration and insurance details and financing arrangements.
- Similar details as respects any ships that the company leases.
- With regard to the proposal as to the employment of staff in Ireland, the identification of the personnel.

4.14 This type of information is requested in order to assist Revenue in assessing the validity of any claim that the centre of a company's strategic and commercial management is, or will be, in Ireland. In the absence of such information Revenue could refuse to give the necessary comfort to a company that it will, on the basis of the information provided, be regarded as a "qualifying company". While such information has generally been forthcoming, some resistance to providing some of this information has been encountered (particularly as respects information on ownership). In order to ensure that the strategic and commercial management of a company will actually take place in Ireland, Revenue considers it <u>essential</u> that it be able to acquire this type of information. It also allows for a "quality control" test to be applied with a view to excluding as far as possible "brass-plate" type operations from the regime. It is also considered that such a rigorous approach might also help keep out possible undesirable operations that might expose the country to a potential reputational risk. Accordingly, there may be a need for the legislation to be amended so that Revenue has the power to require that this type of information be produced if entry to the regime is sought[244].

> **Finding**: There would appear to be a gap in the legislation in terms of the administration of the scheme. Revenue has experienced some difficulty in obtaining information at the required level of detail to be fully satisfied as to the bona fides of applicants. At the same time some agents seem to be somewhat frustrated at the absence of formal structures governing application, informational requirements and status of Revenue's approval before a potential applicant formally elects into the scheme.

Income Sources Covered by Tonnage Tax

4.15 The most important income sources which are covered by the tonnage tax calculation are:

- Income from activities which are related to the actual operation of a qualifying ship (for example, profits from the carriage of cargo or passengers at sea).

- Income from activities carried out on board qualifying ships that are ancillary to these activities such as the operation of cinemas, bars, shops, restaurants, etc. where the goods and services provided are consumed on board a qualifying ship.

- Income from activities that are undertaken in order for these shipping operations to be undertaken (such as embarkation/disembarkation services, tickets sales, hire of containers, etc).

- Income from the provision of ship management services for qualifying ships.

[244] For the tax agents view of this see **paragraph 8.4**.

Treatment of Capital Allowances, Losses and Other Reliefs

4.16 Capital allowances, balancing charges and capital gains[245] are not a part of the tonnage tax scheme once a company is established in tonnage tax. However, these matters do come into play in relation to certain transitional arrangements which may leave companies open to some balancing charges and some capital gains charges in relation to assets acquired before entry to tonnage tax. These charges, however, will not arise until a ship is sold and even then reliefs are available which will defer any balancing charge if there is re-investment in a new ship or reduce or eliminate any such charge by reference to either the time the company has been in tonnage tax or to unrelieved losses incurred before entry to tonnage tax.

4.17 A company cannot use losses[246] carried forward from any period before entry into the tonnage tax regime to reduce tonnage tax profits. Such losses are therefore effectively extinguished. Certain tax credits and reliefs (including, foreign tax credits) are not available to reduce the corporation tax payable by a company to the extent that the corporation tax is referable to tonnage tax profits.

5. CALCULATION OF "PROFITS" UNDER TONNAGE TAX

5.1 The tonnage tax "profits" of a qualifying company replace the company's accounting profits for the purposes of applying corporation tax to those profits. However, only the "relevant shipping profits" of the company are displaced for this purpose. The normal accounting profits of the company adjusted for taxation purposes from all other activities are subject to corporation tax in the normal way. e.g. rental income, investment income, profits from sale of holiday accommodation etc.

5.2 The tonnage tax profit is calculated on the basis of a notional daily profit per ship based on a sliding tariff by reference to the net tonnage of the ship (see **Table 1**). This notional profit per ship is then multiplied by the number of days the ship was operated in the accounting period by the

245 Sections 697M, 697N and 697O of the TCA 1997 refer.
246 Section 697M TCA 1997

company to get the profit per ship for each accounting period. The profit per ship is aggregated to get the company's overall tonnage tax profits for the accounting period. The 12.5% corporation tax rate is then applied to this profit instead of being applied to the company's relevant shipping profits.[247]

Table 1: Calculation of Tonnage Tax Profits

Band	***Rate per 100 ton unit***
For each unit of 100 tons up to 1,000 tons	**€1**
For each unit of 100 tons between 1,000 tons and 10,000 tons	**€0.75**
For each unit of 100 tons between 10,000 tons and 25,000 tons	**€0.50**
For each unit of 100 tons above 25,000 tons	**€0.25**

5.3 Perhaps the best way of showing how the tonnage tax profit and tax calculation works in by way of an example. The example set out in **Appendix I.1** involves a shipping company that operates two qualifying ships of 12,500 tons net each. One of the ships has been in use by the company for the full accounting period. The other has been purchased six months into the accounting period of the company. The company operates a standard 12 months accounting period that coincides with the calendar year.

6. TONNAGE TAX STATISTICS

Number of Ships and Companies

6.1 **Table 2** sets out the number of companies and the number of ships in tonnage tax as of September 2005. It includes those companies whose applications are under active consideration by Revenue. It is to be noted that companies in the scheme operated 30 ships under tonnage tax in 2002;

[247] Section 697C TCA 1997 sets out the rules for the calculation of the tonnage tax profits of a tonnage tax company.
[248] The 2004 figure is provisional and based on information from entrants in 2004. Companies already in tonnage tax may have bought or sold ships or have brought on-shore ships that were off-shore in 2003. Such matters will only be reflected in the figures when the 2004 returns are received.

this had risen to 39 in 2003; and to 44 in 2004[248]. The ships are spread across 18 companies in 4 groups.

Table 2: Tonnage Tax: Companies and Ships[249]

Position as of 2005	*Approved*	*Under consideration[250]*
Number of Groups	*4*	*Final structure not clear*
Number of Companies	*18[251]*	*8[252]*
Number of Ships	*44*	*10*

6.2 **Table 3** sets out the net tonnage of the ships in tonnage tax. This table shows an increase of 48% in the net tonnage of Irish registered ships in tonnage tax between 2002 and 2003 (from 46,938 net tons to 69,538). The Irish Marine Development Office (IMDO) attributes to tonnage tax a 68% increase in the Irish registered tonnage between 2001 and December 2003[253]. The difference can probably be explained by timing factors due to applicant companies, of necessity, acquiring ships (which would have been counted by the IMDO) in advance of their tonnage tax applications being fully processed. Revenue has sufficient details from two of the applicant companies[254] to estimate that an additional 9,000 tons could be added to the tonnage tax base in 2005. This would bring the Revenue estimate for the increase in the tonnage between the first year of the scheme, that is, 2002 and the end of 2005 to more or less 68% (from 46,938 to 78,538).

Finding: Tonnage tax seems to have been responsible already for between a 48% and a 68% increase in the Irish registered tonnage depending on the estimation method used.

[249] Source: Revenue.
[250] The cases under consideration all involve new companies, that is, companies that have either established a presence in Ireland to enter tonnage tax or Irish companies that intend to enter the business.
[251] Of the 18 companies, 9 are in one group; 5 in another; 3 in another and one single company.
[252] One application is in abeyance and Revenue has indicated that another applicant cannot be regarded as a "qualifying company".
[253] See **paragraph 8.2**.
[254] Without counting the major Irish based shipping company which joined in 2004.

Table 3: Net Tonnage of Ships in Tonnage Tax[255]

Year	*Tonnage of ships*
2002	46,938
2003	69,538
2004	Not available: returns due from Sept. 2005

6.3 In addition to new companies establishing in Ireland, there seems to be a suggestion of ships returning to the Irish register from non-resident companies ultimately owned by an Irish resident shipping group.

Tax paid in Tonnage Tax

6.4 **Table 4** sets out the tax paid in tonnage tax for the years 2002, 2003 and an estimate for 2004[256]. These figures take no account of corporation tax paid under the normal corporation tax system by tonnage tax companies on non-tonnage tax profits. Such activities would include the profit on the road transport part of a combined land/sea transportation contract; profits from provision of car-parking facilities and land transportation tickets (e.g. train/bus tickets); profits from the sale of holiday accommodation; profits from sale of goods and services on board ship which are not for consumption on board; and investment income of the company.

Finding: Having regard to the rates tonnage tax is levelled at it is virtually a tax exemption for shipping companies as respects their shipping income.

[255] Source: Revenue from tonnage tax returns.
[256] Source: Tonnage tax returns and direct contact by Revenue with tonnage tax companies.

Table 4: Tax paid in Tonnage Tax[257]

Year	*Tax Paid*
2002	*€17,000*
2003	*€22,000*
2004	*€41,000 (estimate)*

Tax Costs of Tonnage Tax

6.5 Because tonnage tax profits are returned to Revenue instead of the actual profits from the activities covered by the tonnage tax calculation, it is not possible to directly compare the tax paid under tonnage tax and the tax which would have been paid if there were no tonnage tax. Indeed, for the reason set out in **paragraph 6.7** it is doubtful as to whether any such comparison would be valid.

6.6 In considering potential costs of tonnage tax it is also, perhaps, worthwhile keeping the following in mind:

- It is generally accepted that one of the primary reasons for the introduction of tonnage tax was to ensure that Irish shipping companies remained in Ireland. If tonnage tax had not been introduced it was widely believed that there would be very little Irish shipping industry to pay tax of any description. In this light, the introduction of tonnage tax can be seen as not having imposed any costs on the Exchequer in terms of tax foregone. Indeed, as it has achieved its primary aim of retaining an Irish shipping industry there is arguably a gain in terms of tax paid (both at the tonnage tax level and in terms of other tax contributions made by the companies concerned and their employees).
- To the extent that the Irish tonnage tax has succeed in attracting a certain amount of inward investment, which almost certainly would

[257] Source: Revenue from tonnage tax returns.

not have happened in the absence of tonnage tax, it could again be argued that tonnage tax has resulted in a net tax contribution to the exchequer rather than a cost.

> **Finding**: Having regard to the decision of the main Irish shipping companies to retain their base of operations in Ireland and the increase in the registered Irish tonnage, it can be argued, albeit anecdotally, that tonnage tax is not a cost to the Exchequer.

Tax Computations

6.7 A direct comparison between the tonnage tax profits and the income from the activities sheltered from taxation by the tonnage tax calculation does not give a correct picture. The profit for tax purposes on this income would first have to be calculated. This figure would not be the same as the ordinary commercial profits from the activities. Once the profit for tax purposes was calculated it would be necessary to deduct various tax reliefs and allowances. For example, the profit for tax purposes would need to be reduced by any losses which would have been carried forward from periods before tonnage tax. Likewise any capital allowances due for the period would have to be deducted. Allowance would also have to be made for any other deductions and reliefs that might have been available. There is no need in tonnage tax for a company to undertake the complex tasks of keeping track of losses forward and of the use or non-use of capital allowances. In this context it would seem somewhat onerous to place a requirement on companies to do two tax computations one for tonnage tax and one as if they were not in tonnage tax. As tonnage tax is specifically designed to take tax based decisions out of the equation (e.g. as respects financing of ships) it is likely that within a few years there would be little benefit to be gained from any such comparison as the tax computation would, at that stage, bear very little resemblance to what would have been the computation if the company had never entered tonnage tax and the company had continued to make tax based rather than commercially based investment decisions.

Finding: To fully cost tonnage tax in terms of what would be payable by a company if tonnage tax did not exist would require a tonnage tax company to submit two tax returns - one showing the tax payable under tonnage tax and the other showing the tax that would have been payable if tonnage tax did not apply. This is too onerous a compliance burden to place on companies having regard to the immediately preceding finding and the reason for that finding. Having regard to the reasons for the introduction of tonnage tax, a measurement of the health and growth in the Irish shipping fleet using the position obtaining at the time of the introduction of tonnage tax as a base line would be a better method of evaluating its cost/benefit to the Exchequer.

The "Counterfactual"

6.8 In evaluating tax incentives generally it is often very difficult to estimate or decide on what would have happened in the absence of the incentive in question (this task is often referred to by economists as "evaluating the counterfactual"). In the context of this review, evaluating what might have happened if tonnage tax had not been introduced is of key importance. It is also relatively straight-forward if, as would seem to be generally accepted, the introduction of tonnage tax resulted in the main Irish shipping companies remaining in this country. On this basis, it is quite possible that in the absence of tonnage tax there would not, at this stage, be very much in the way of an Irish shipping industry.

Finding: The primary objective of introducing tonnage tax has been achieved, namely, the retention in the State of the operational base of the main Irish shipping companies.

Deadweight

6.9 The issue of deadweight involves separating out the contribution tonnage tax has made to maintaining and/or increasing the size of an Irish-based shipping industry as against the level of shipping activity that would remain or come to Ireland if there were no tonnage tax. Looked-at in this light it is possible to conclude that there is little or no deadweight in the tonnage tax scheme. The main Irish based shipping companies who may have been considering disengagement from Ireland have stayed and have entered tonnage tax.

6.10 Given the prevalence of tonnage tax regimes in EU member states and elsewhere, it is also possible to conclude that very little of the increase in the Irish shipping fleet since the introduction of tonnage tax would have occurred in its absence. As tonnage tax delivers almost a zero rate of tax this conclusion stands-up notwithstanding our 12.5% rate of corporation tax.

Displacement

6.11 In the context of tax incentives, displacement is usually considered to occur when economic activity resulting from the introduction of an incentive takes place at the expense of existing activity within the sector incentivised. As tonnage tax was designed, primarily, to maintain the existence of an Irish based shipping sector (with a secondary objective of encouraging foreign direct investment into the Irish shipping sector), it is difficult to see what, if any, displacement has occurred.

> **Finding**: Having regard to the findings generally in this section, the deadweight involved in tonnage tax is minimal and there is no evidence of displacement.

High Earners

6.12 Tonnage tax is a corporate tax relief. Individuals who own ships cannot enter the scheme unless they incorporate a company and transfer the ownership of the ship to the company. The benefits of tonnage tax in tax terms only operate at the company level to effectively shelter the shipping profits of a shipping company from corporation tax. The company’s profits on distribution to individual shareholders who are Irish residents are, in the first instance, subject to dividend withholding tax (DWT) at the standard rate of tax. Companies are obliged to withhold and pay over to Revenue the tax due under DWT from the dividends paid to an Irish resident shareholder. In addition, the shareholder is ultimately liable to income tax on the dividends at his or her marginal rate of income tax with a credit for any DWT already paid by the company. Moreover, individuals are specifically prohibited from obtaining capital allowances in respect of ships leased to tonnage tax companies. Such capital allowances are only available to corporate lessors (and then only on a ring-fenced basis)[258].

> **Finding**: Tonnage tax cannot be used by high earners as part of a suite of tax reliefs and exemptions to reduce their tax liabilities significantly.

7. ANTI-ABUSE MEASURES

7.1 The tonnage tax regime is a relatively new taxation regime and there are a relatively small number of companies using the scheme at present. Revenue is not aware of any abuses of the regime and none of the companies within the scheme appear to give rise to concern about the appropriateness of tonnage tax[259]. It should be emphasised, however, that Revenue audits have not yet been carried out on any of the companies that have been accepted into the regime to date.

7.2 The legislation as drafted contains a number of specific anti-abuse measures. In addition, as set out in **paragraphs 4.12 to 4.14** Revenue have applied tight administrative control on applications for entry to the scheme to ensure that applicant companies are genuine qualifying companies within the terms of both the intent and the actual wording of the legislation. In particular, detailed information and evidence of intentions is sought to ensure that the "strategic and commercial" management test is satisfied (i.e. that the applicant company carries on the strategic and commercial management of the qualifying ships in the State). Thus far Revenue has refused to provide the necessary clearance to one applicant on the basis that this test has not been satisfied.

[258] See sections 697O(2) and 407 TCA 1997.
[259] The IMDO are also unaware of any abuse and moreover are unaware of any instance of abuse in any other EU tonnage tax regime.

Recreational Vessels

7.3 The legislation specifically excludes from tonnage tax vessels "of a kind whose primary use is for the purposes of sport or recreation"[260]. No such vessel has been allowed use the tonnage tax regime; despite claims to the contrary in the media. The published Revenue guidance on tonnage tax[261] confirms that a vessel (e.g. a holiday yacht) that is chartered as a whole by its passengers either by a passenger acting alone, passengers acting together or by a third party on behalf of one or more of the passengers will be regarded as a vessel of an excluded kind and so will not qualify for entry into tonnage tax. However, the notes make it clear that the provision will not be interpreted in a way that excludes cruise liners which take individual fare paying passengers. There may be a case for tightening up and placing on a statutory basis the rules allowing genuine cruise ships in and keeping pure recreational vessels out of tonnage tax. It should be acknowledged that the approach set out in the Revenue guidance was adopted at the time because of difficulties in coming up with a sufficient robust statutory wording that effectively excluded certain luxury private vessels from tonnage tax while allowing commercial cruise vessels into tonnage tax.

> **Finding**: While the legislation specifically excludes from tonnage tax vessels whose primary use is for sports or recreational purposes, there may be a case for tightening-up and placing on a statutory basis the rules allowing genuine cruise ships into, and keeping purely recreational vessels out of, tonnage tax.

Ring-fencing Measures

7.4 There are extensive ring-fencing measures that are designed to ensure that advantage is not taken of the tonnage tax regime to include income from non-tonnage tax activities or to get tax relief for losses incurred on tonnage tax activities against other sources of income. These include arm's length

[260] Section 697A(1) TCA 1997.
[261] 2003 Notes for Guidance on the Taxes Consolidation Act 1997 at page 1997.

pricing that require goods and services provided to a tonnage tax company by an associated non-tonnage tax company to be provided on an arm's length basis and vice versa. This provision also applies where a tonnage tax company has a number of business units some of which are covered by the tonnage tax regime and others of which are not[262]. Anti-thick capitalisation measures are also included. A company is "thickly" capitalised if it is fully financed by share capital and borrows little or nothing. In general, however, most companies are financed by a mixture of equity finance and loan capital. Companies in the tonnage tax regime do not get a tax deduction for interest paid on borrowings. Therefore, there is scope for the artificial allocation of debt within a company or group so that the debt that is in reality referable to the tonnage tax business is transferred to its non-tonnage tax activities where a tax deduction for interest paid would be of most value. The legislation deals with such a case by re-allocating a portion of the interest charge to the tonnage tax side of the business on a just and reasonable basis[263]. Anti-avoidance measures are also included to prevent the regime from being used for tax avoidance activities and transactions.

Capital Allowances

7.5 Under tonnage tax the profit given by the tonnage tax calculation cannot be reduced by the use of capital allowances. However, under normal tax rules capital allowances are available to both owner/users of ships and to lessors (e.g. banks) of ships. As a shipping company in tonnage tax would have no use for capital allowances it was recognised that there would be a considerable incentive to transfer capital allowances to other persons through such devices as sale and lease back arrangements. Such devices should not be viewed as mere tax avoidance schemes, as, given the high capital cost of ships, there is a real commercial need for the provision of finance to purchase new ships. Without the availability of capital allowances for lessors it would be difficult for shipping companies to raise the required finance. It was also realised that the difference in corporate

[262] Section 697LA of the TCA 1997.
[263] Section 697LB of the Taxes Consolidation Act 1997

and individual tax rates meant that there would be a very significant incentive to transfer capital allowances from the shipping sector, where they could not be used, to individual lessors. Accordingly, the legislation allows capital allowances that are referable to assets used by tonnage tax companies to be available for use by corporate lessors but only on a ring-fenced[264] basis, and, on Exchequer cost grounds, individuals are excluded.

Abuse of the Regime

7.6 It is a condition of remaining in tonnage tax that a company not be a party to anything that would be an abuse of the regime[265]. A company engaging in tax avoidance using the tonnage tax regime may be expelled from the regime. Expulsion is appealable to the Appeal Commissioners. Expulsion results in a clawback of any exemption given in respect of capital gains or relief given for balancing charges during the time in tonnage tax. No reliefs whatever can be set against the amounts brought back into charge[266]. Finally, a company expelled from tonnage tax is disqualified from re-joining for a 10-year period[267].

> **Finding**: Initial indications are that the scheme is working as intended. The scheme does contain a number of anti-avoidance measures but abuses could still arise. A final assessment of this will have to await a Revenue audit of a tonnage tax company.

8. THE VIEWS OF THE IMDO ON TONNAGE TAX

Success of tonnage tax

8.1 The Irish Maritime Development Office (IMDO) which is the body charged with the development of the Irish shipping sector were invited to give their views on tonnage tax. The IMDO believes that Irish tonnage tax was successful in its principal objective. Ireland's principal shipping companies elected to Irish tonnage tax thus securing the Irish shipping industry.

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264 The allowances may only be set off against income form the lease – see section 407 TCA 1997.
265 Section 697F TCA 1997.
266 Section 697P TCA 1997.
267 Section 697Q TCA 1997.

8.2 The IMDO also report that the introduction of tonnage tax also led to additional industrial benefits to the industry since 2001:

- The introduction of tonnage tax in Ireland led to a 68% increase in the Irish registered tonnage and approximately 17% increase in employment in the sector between 2001and December 2003.
- The Irish tonnage tax has also attracted a number of maritime transport and maritime service firms to the country, eager to capitalise on the long-term strategic potential of their businesses.
- The announcement of the Irish tonnage tax in Budget 2001 led to several Irish banks and financial institutions investing in the ship finance market through recruitment of specialist ship finance staff.
- All of the major tax and finance consultancy firms are currently and actively engaged in the marketing of Ireland's tonnage tax to international shipping firms with some success.
- Several major Irish legal firms have also invested resources in recruiting and building expertise in the maritime transport sector.
- A number of international shipping and shipping related businesses have also established operations in Ireland;

Finding: The agency responsible for the development of the shipping sector is of the view that the scheme has achieved its principle objectives and has also lead to considerable additional investment, employment and other activity in the Irish shipping industry and related sectors.

8.3 The IMDO also report that some tax advisors have expressed concerns to the IMDO over Revenue's administration of the scheme, including:-

- Delays and lack of certainty over business plans submitted.
- Inability to obtain a ruling on a tonnage tax business proposal.
- No binding rulings available from the Revenue Commissioners.
- No clear Tonnage Tax application process.

8.4 Revenue in response pointed out that any “certainty” or “uncertainty” with business plans might have more to do with the content of the plans than with what Revenue did with the plans; that the particular “ruling” sought was outside the terms of the legislation; also that the legislation makes no provision for binding rulings. Indeed, as the applications in question are prospective in nature there could be no question of Revenue providing “binding” rulings. Revenue are prepared to give opinions on matters put to it based on the information supplied at the time but this cannot be regarded as binding on an inspector who subsequently audits the company in question should some of the information supplied later prove to be incomplete or incorrect.

8.5 The IMDO also acknowledged that the criteria for qualifying for tonnage tax are quite clear and based largely on the strategic and commercial management substance of the tonnage tax company. According to the IMDO, companies simply wish to ensure that all relevant aspects of their business are clearly within tonnage tax before electing for a 10-year period. It is the view of some tax advisors, as articulated through the IMDO, that the decision to establish an operation in Ireland comes with significant risks. Companies are keen to ensure that, having invested in a tonnage tax operation, all relevant activities will be within the Irish tonnage tax and it will not be subject to penalties at a later date. The ability to enter into discussions with the Revenue Commissioners would resolve many of these issues in addition to having clear response times from the Revenue Commissioners when queries are submitted (see also par. 4.14 above). Revenue had extensive discussions with applicants and has provided guidance on what in its opinion would be necessary for a company to qualify for tonnage tax. Revenue would be prepared to publish guidance on what details should be submitted and setting out likely timelines for dealing with applications where all necessary information has been supplied in a satisfactory manner.

8.6 The IMDO acknowledge that, as applications to enter the scheme increase, so too will Revenue's familiarity with the industry and its ability to provide guidance to applicants. Revenue agrees with this statement but pointed out that in its view much of the delays occur in obtaining detailed and conclusive information from some agents and/or principals.

9. RECENT EU DEVELOPMENTS AND IMPLICATION FOR IRISH SCHEME

9.1 In 2004 the European Commission produced a review of its 1997 State aid guidelines to maritime transport in Commission communication (C (2004) 43) – *Community guidelines on State aid to maritime transport*[268]. This further endorsed the introduction of tonnage tax regimes.

9.2 The 2004 EU state aid guidelines, unlike the old guidelines, do not include a requirement that limits the amount of tonnage a company may time charter-in to 75% of that company's fleet's tonnage[269]: The Dutch Government[270] has recently received approval from the EU Commission for amendments to its regime to remove this requirement. In all other tonnage tax regimes, Ireland included, owners and operators can only time charter-in tonnage equivalent to three times the owned or bareboated tonnage. From a commercial viewpoint, removing this restriction allows a company operating within Dutch tonnage tax a considerably greater flexibility in its business and a significant competitive advantage.

Finding: The liberalisation of the EU State Aid rules mean that Ireland can review the requirement limiting to 75% the ships operated by a company in tonnage tax that can be chartered-in.

[268] OJ C 13, 17.1.2004, p. 3.
[269] See section 697E TCA 1997.
[270] Source: IMDO

10. LIST OF RECOMMENDATIONS

10.1 The recommendations derive directly from the Review's findings and conclusions and are as follows:

- Tonnage tax should be retained as part of the State's support to the shipping sector, with the adjustments as set out in the recommendations following.
- The legislation should be amended to empower Revenue to require information on the structure and organisation of applicant companies; the beneficial ownership of the shares in such companies; ship registration and financing details; details as to actual and future employment and identification of personnel; copies of business plans; and any other information considered necessary to allow Revenue arrive at a considered opinion as to the bona-fides of a company.
- The legislation should be amended to provide a formal application process, including provision for prescribing forms, elections, etc. In addition, Revenue should consider publishing guidelines on the details to be submitted with applications including setting out likely timeframes for dealing with applications where all information requested has been supplied in a satisfactory manner.
- Companies should not be required to provide duplicate tax computation, one using the tonnage tax rules and another using normal corporation tax rules.
- As an alternative to providing duplicate tax computations, companies in the scheme could be required to provide the Department of Communications, Marine and Natural Resources with sufficient up-to-date economic and commercial information to enable policy makers to access the costs/benefits of the scheme to the Irish shipping sector and the economy generally in terms of the development and health of the sector (e.g. number and tonnage of ships, employment and additional economic activity in the sector - both on board and ashore) using the state of the industry at the time of the introduction of tonnage tax as a base line.
- The legislation should be amended to ensure that the statutory prohibition on purely recreational craft accessing the scheme is as robust as possible.
- The legislation should be changed to remove the requirement limiting to 75% the tonnage of ships operated by a company that can be chartered-in.

Appendix I.1 – Example of Tonnage Tax Calculation	
STEP 1 – calculate profit per day per ship	
The calculation is made by reference to an amount of profit per day per ship by reference to each unit of 100 tons as follows:	
Each unit of 100 tons up to 1,000 tons @ €1………..	*€10*
Each unit of 100 tons between 1,000 and 10,000 @ €0.75 (90 * 0.75)………………………………………………	*€67.5*
Each unit of 100 tons between 10,000 and 25,000 tons @ €0.50 (25 * 0.50)………………………………………	*€12.5*
This gives a profit per day per ship of……………………..……	*€90*
STEP 2 – calculate the profit per ship for the accounting period	
Ship 1: Ship operated by the company for full period (365 * 90)	*€32,850*
Ship 2: Ship operated by company for 2nd half of accounting period (184 * 90)………………………………………………	*€16,560*
STEP 3 – Calculate company's tonnage tax profits	
Aggregate the profit for each ship used in the accounting period to get tonnage tax profits of company for the accounting period (€32,850 + €16,560)……………………………………………	*€49,410*
STEP 4 – Calculate corporation tax due	
Applying the corporation tax rate of 12.5% to the tonnage tax profits of €49,410 we get tax due for the year of ………………	*€6,176.25*

Appendix I.2

Tonnage Tax Type Regimes in the EU and the EEA

By 2004, the following EU member states (including EEA member states) had introduced tonnage tax regimes or corporate tax regimes providing a comparable or more favourable benefit:

1970's	Greece[271]
1996	Netherlands
1996	Norway (EEA)
1999	Germany
2000	UK
2002	Ireland
	Denmark
	Spain
	Finland
2003	France
	Belgium
	Italy

Cyprus has various shipping taxation regimes including a variation on tonnage tax which is considered compatible with EU guidelines.

Malta has various shipping taxation regimes including a variation on tonnage tax which is considered compatible with EU guidelines.

Portugal operates a complete offshore haven for maritime activities through Madeira and tonnage tax is under discussion for the mainland.

[271] The Greek regime while referred to as a tonnage tax is not based on the EU model and is highly restrictive.

Appendix I.3

Comparison of Irish Tonnage Tax with other EU Countries[272]

1. Tonnage Tax regimes across Europe are almost identical. Before the European Commission revised the State aid guidelines for shipping in 2004 Ireland's regime had a competitive advantage over other EU regimes by virtue of allowing ship management companies access to tonnage tax. The 2004 revised state aid guidelines recommend that all regimes now allow access to ship management companies.

2. Only the UK and Germany currently have tonnage tax regimes that contain requirements considered restrictive by shipping companies. These are –

    - in the case of the United Kingdom, a cadet training requirement, and
    - in the case of Germany, a German flag requirement.

3. In all other respects, tonnage taxes are calculated in the same manner and apply to largely the same company types and vessel types. Differences that do exist relate to the local tax rate. Ireland's tonnage tax is the lowest in Europe by virtue of the 12.5% corporation tax rate. However, effective tax rates under tonnage taxes are so low as to make differences between the final tax liability negligible. This, of course, merely reflects one of the main reasons for a tonnage tax system, namely, to remove tax from the considerations governing a shipping company's decision to locate its business.

4. Certain countries have additional financing benefits that have had an exaggerated effect on the number of companies applying for tonnage tax status, for example Germany and its KG limited partnership scheme. Germany operates a highly lucrative limited partnership scheme where private individuals can offset corporate (limited partnership) losses against their personal income taxes. These limited partnerships have typically used the losses for three years before they back their shipping assets into a company which then elects for German Tonnage Tax. Investors can

[272] Source: IMDO.

ultimately benefit from both a generous capital allowance regime over a 3 year period followed by an almost tax free income from their Tonnage Tax company. There are, however, proposals in Germany to tighten up this by providing for an "either/or" option, that is, either the limited partnership capital allowances scheme or the tonnage tax scheme but not both.