IFA Submission to Government on Reform of PRSI, Levies and Income Tax System

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1 Introduction – Budget 2010 Statement on Reform of Income Tax

In his 2010 budget statement, the Minister for Finance, Mr. Brian Lenihan TD, made the following statement under the heading: "Reforming how we tax income":

"*It is also clear that our income tax system has become very imbalanced. Next year almost half of income earners will pay no income tax and 4 per cent will pay almost half on the total yield. If we want to sustain high levels of Government services this imbalance must change. The time has come to transform how we tax incomes, to simplify it, to make it fairer and more broadly based.*

It is my objective to introduce in 2011 a new system of just two charges on income.

A new universal social contribution will replace employee PRSI, the Health Levy and the Income Levy. It will be paid by everyone at a low rate on a wide base as a collective contribution to public services.

Income Tax will apply on a progressive basis to those with higher incomes reflecting their capacity to make a greater contribution".

1.1 IFA's Strategy on Reform of the Method of Taxation of Income

IFA welcomes the intention of the Government to reform the method of taxation of income. The present system, involving four different charges on income, involving different definitions of "income", and with widely different entry points, ceilings and exemptions, is unduly complex. It is also inequitable in a number of areas.

IFA has highlighted two major objections to the current system in our 2010 budget submission:

(i) Method of assessment of farm income for payment of the Income Levy

The Income Levy introduced in the 2009 budget and doubled in the supplementary budget seriously discriminates against farmers because of the method of assessment of farm income. Unlike the definition of "income" which applies for income tax, health levy and PRSI levy payments, the income levy applies to" gross income" prior to the deduction of capital allowances. This results in major discrimination against farmers whose businesses require a significant amount of ongoing capital investment, and who have undertaken a major investment in farm buildings and facilities in recent years in order to comply with environmental regulations.

(ii) Inequity in the tax credit system (Income Tax)

Tax credits (which replaced the previous system of personal allowances) determine both the entry point at which income becomes liable for taxation, and also the total tax liability for a particular level of income. This involves sectoral discrimination within the income tax code.

Farmers and other self-employed taxpayers have been denied significant personal tax credits available to employees and others paid through the PAYE system. This anomaly continues to apply, despite the fact that the self-employed are taxed on a current year basis. The PAYE personal tax credit now amounts to €1,830. This provides a tax saving of up to €3,660 to a household with two PAYE incomes when compared with a farm family household.

The exclusion of self-employed taxpayers from the PAYE tax credit is particularly penal at low-income levels. A self-employed taxpayer (single) becomes liable to pay income tax at an income level of €9,150/year, whereas an employee (single) is not liable to pay income tax until an income of €18,300 is reached. It should also be noted that the PAYE credit is not just confined to earned income; people on pensions who are paid through the PAYE system also qualify.

1.2 A Single Definition of Income for Taxation and Social Contribution purposes

The Commission on Taxation report (September 2009) recommends, "there should be a single system which collects tax on income". It also notes that the Income Levy may be seen as a mechanism devised as a temporary measure.

Under the current tax system, all farmers are obliged to register with the Tax Authorities and receive a Personal Public Service number (PPSN). It is at the discretion of the Tax Authorities to decide if the size and scale of the farm business warrants exemption from having to submit income tax returns annually. Unless exempted by the Revenue Commissioners from submitting an income tax return, farmers are obliged to file the income tax return whether or not they have been requested to do by the Revenue Commissioners.

IFA supports the broad objective of a single system of measuring income of farmers (and indeed all taxpayers) for the payment of both Income Tax and the new Social Contribution in the future. As regards the method of an assessment of farm income, IFA submits that the system used for income tax purposes should form the basis of a single system. However, IFA recognises that as regards the details, some forms of income that are not liable to Income Tax would be liable to the Social Contribution. (An example is income from Forestry).

1.3 Calculating Farm Profit for Income Tax Purpose

The present system of calculating farm profit for income tax purposes has been developed over the years, since farmers first became liable to income tax in 1974. Income tax is levied on farm profit, which includes:

a) On the receipts side, all incoming revenue to the farm, which mainly consists of (i) sales of farm products and (ii) direct payments.

b) On the expenses side, all input costs and expenses that are incurred wholly and exclusively in carrying out the farming trade.

Normal reliefs relevant to the calculation of taxable farm profits include (i) current production costs, for example, feed, fertilizer and energy, (ii) capital allowances, and (iii) relief specific to the nature of farming including income averaging, stock relief and valuation of livestock.

1.3.1 Simplified System of Farm Income Assessment for Low Income Farmers and Farmers with a Non-Complex Farming System

All farmers should have the choice of submitting full farm accounts for tax purposes. However, in the current low-income situation in farming the requirement to have farm accounts and related tax return prepared professionally is a substantial cost burden on these small businesses. Also, some farmers operate a non-complex farming system (e.g. single enterprise, relatively few transactions with a small number of suppliers and purchasers, little capital investment, and little charge in the system from year to year).

The introduction of the broadly-based Social Contribution makes it more urgent that a simplified system of farm income assessment is in place. IFA proposes that a simplified system of farm income assessment be introduced in 2011 in conjunction with the Social Contribution. IFA sets out the basis of such a system in Section 3.3 following.

2 SOCIAL CONTRIBUTION

2.1 New Universal Social Contribution – IFA Position on Relevant General Issues

2.1.1 Retaining the Social Insurance Model

Because this new charge is replacing Social Insurance (PRSI), a number of general issues must be accommodated.

(i) **The "social insurance" model should be retained.** Under social insurance, people have entitlements to certain state schemes and benefits, based on a record of contributions. However, as regards the State (PRSI) pension system, it is clear that the present system contains many anomalies and requires substantial reform by Government.

(ii) **Within the social insurance system, fundamental differences exist between the model covering employees and the model covering self-employed people**. This arises from the fact that the self-employed do not require the same broad cover as employees, e.g. cover for unemployment is relevant to employees but not self-employed. The following extract from the Commission on Taxation report gives a useful overview of PRSI:

"In the two most common PRSI contribution classes (A1 and S1), PRSI applies at a rate of 4% on reckonable earnings of employees, 3% on reckonable income of the self-employed and there is a charge on employers at a rate of 10.75% of their employees' reckonable earnings. The base for the self-employed is wider than that for employees but the rates applying are different. We consider that a similar base should apply to employees and the self-employed and a single rate of charge should apply.

Employer PRSI should be regarded as a payment to cover employment-related benefits, such as jobseeker's benefit, illness benefit, occupational injuries benefit and health and safety benefit which are available only to employees, while other benefits, which are available to all workers should be linked to the employee and self-employed PRSI".

(iii) Social insurance cover for self-employed spouse. Within the self-employed PRSI system, self-employed spouses working together in a business or farm can avail of cover provided they apportion their income when making income tax returns, make the relevant PRSI contribution, and meet the conditions to qualify as a spouses partnership (details in Department of Social and Family Affairs booklet SW124). **This method of providing cover for self-employed spouses for contributory State benefits, particularly contributory pensions, must be maintained in the new Social Contribution system.**

(iv) Proposed additional social insurance cover for farmers under the Social Contribution. Notwithstanding point (ii) above, one specific risk factor in the case of farmers (and other self-employed) which could be best managed under a social insurance system is Long-term Invalidity / Disability. Indeed, this issue was discussed in the original National Pensions Board Report 1988, which lead to the extension of social insurance to the sef-employed. IFA considers that in the case of farmers, cover for short-term illness is best provided by private insurance.

However, long-term invalidity / disability is a major risk factor for farmers, taking into account the family farm structure of farming and also the physical nature of farm work.

While the present PRSI system provides farmers with cover for contributory pensions, and some other relatively minor benefits, the introduction of the Social Contribution (at a likely higher rate than the PRSI contribution) is an opportunity to review the level of cover for self-employed. **IFA proposes that cover should be provided for long-term Invalidity / Disability. IFA recognises that the qualifying conditions for Long Term Invalidity / Disability for self-employed people is a relevant issue that would have to be addressed.**

2.1.2 Some Relevant Implications for Social Assistance

IFA wishes to make the following points:

(i) Currently, the means-tested (Social Assistance) system applies for people on low incomes. It is expected that in the new Social Contribution system, the coverage of the Social Contribution will be broader, and thus the reliance on means-tested schemes reduced over time. **However, a means-tested social assistance system will be required in the future.**

(ii) The "Farm Assist" scheme plays an important role in enabling about [9,500] low income farmers to stay working in agriculture in a cost-effective manner to the exchequer. This is a parallel scheme to the "Family Income Supplement" which enables low-income employees take-up or retain employment rather than the alternative of unemployment. **The Farm Assist scheme must be retained in the reformed income support system.**

2.2 Social Contribution – IFA Proposed Principles

a) The income base on which the Social Contribution is paid should be broad;

b) In return for a broad contribution base, the contribution rate should be relatively low;

c) The Social Contribution should be implemented in a way that encourages employment and minimises unemployment traps; and

d) Allowances should be provided for persons who contribute towards future income security or future costs through (a) pension contributions and (b) private health insurance.

2.3 Social Contribution – IFA Recommendations on Income Base and Other Relevant Issues

A detailed analysis of the current method on income assessment, thresholds and rates for Income Tax and for the existing Levies (Employee PRSI, Self Employed PRSI, Health Levy and Income Levy) is set out in Appendix (I).

Based on this analysis, and on the objectives of achieving a broad base and a relatively low rate for the Social Contribution, IFA makes the following recommendations:

2.3.1 Low income exclusion

Persons with reckonable income of under €5,000/year should be exempt. For persons with reckonable income over €5,000/year, the first €5,000 should be exempt. Where income falls below this threshold on occasional years, the option of a flat-rate voluntary contribution should be provided. For persons over 65 years, the low income exemption level should be €10,000/year. (Figures for married couples are assumed to be double the personal rate in all cases).

2.3.2 Deductible items for Businesses in calculating reckonable income:

For businesses, capital allowances are a normal business expense, and should be deductible in calculating reckonable income. (Currently capital allowances are deductible, except for the Income Levy). Also, trading losses carried forward should be deductible, subject to a minimum contribution level being paid. (This is also a recommendation of the Commission on Taxation).

2.3.3 Deductible items for Persons in calculating reckonable income

Where persons contribute to personal or occupational pensions, this cost should be deductible in calculating reckonable income. Also, where persons contribute to voluntary health insurance, this cost should be deductible in calculating reckonable income.

2.3.4 Rate and Structure of Social Contribution

The Social Contribution should apply to all reckonable income as described above, with no upper income ceiling. The rate should be relatively low and at a single rate.

3 INCOME TAX

3.1 Income Tax – IFA Proposed Principles

a) Income Tax rates must be relatively low to maintain competitiveness and support employment;

b) The system should be progressive, but the degree of progressively should be moderate, in order to avoid excessively high marginal tax rates; and

c) The income threshold at which Income Tax becomes liable should be the same for all earned income, whether as an employee or from self-employment. (see Section 3.2 following)

3.2 Income Tax Threshold Discrimination

It will be recalled that the statement by the Minister for Finance in the 2010 budget as regards reform on the Income Tax system is that "*Income Tax will apply on a progressive basis to those with higher incomes reflecting their capacity to make a greater contribution."*

As regards the present Income Tax system, IFA had highlighted for many years the discrimination against farmers and other self-employed arising from their exclusion for the PAYE tax credit. (see point 1.1 of this Submission).

In the 2010 budget submission, IFA made a specific proposal for an "Earned Income Tax Credit" as a means of ending this discrimination against self-employed people, based on the recommendation in the report of the Commission on Taxation, as follows:

The Commission on Taxation in its analysis recognised that some differences remain in the method of assessment of income between employees and self-employed, but concluded that the size of the Employee (PAYE) Tax Credit is disproportionate to these. The report states *"Rather than differentiating between income from employment and other income, the differentiation in future could be between earned and un-earned income, and a tax credit given to those taxpayers in receipt of earned income. This would recognise the fact that income from both employment and self-employment is earned and would reward effort. It would also compensate for the fact that much passive investment income is taxed at lower levels of tax."* The Commission concluded that this matter should be addressed over time and its recommendation is as follows: "*An earned income credit at a modest level should be phased in over time for proprietary directors and the self-employed*."

IFA proposes that an Earned Income Tax Credit of €1,000 per person should be introduced for self-employed including farmers in the 2011 budget, and phased up to the same level as PAYE tax credit over 3 years.

3.3 A Simplified System of Farm Income Assessment for Farmers on Very Low Incomes

Some low-income farmers are not required to make an annual income tax return. However, on the principle that the Social Contribution is to be broadly based, it is to be expected that many of these will be liable to pay the Social Contribution.

A simplified system of farm income assessment could be based on an "average cost" system, using the independent data from the Teagasc National Farm Surveys (NFS). The individual farmer would submit a verified statement of his farm receipts, i.e. (i) Product sales (less offsetting livestock purchases) plus (ii) Direct payments. An "average cost" would be applied to this figure to give a reckonable farm income figure. The following is the relevant data for the 3 years, 2006, 2007 and 2008 from the National Farm Surveys:

NFS: All Farms - Ireland

Year	2006	2007	2008
Receipts	32,958	37,148	38,203
Net sales*	16,346	16,524	17,467
Direct payments			
	49,304	53,672	55,670
Total Receipts			
Expenses	16,154	16,630	19,358
Direct costs	16,470	17,354	19,319
Overhead costs			
	32,624	33,984	38,677
Total Expenses			
Farm Income	16,680	19,688	16,993
Farm Income as % of Receipts	33.8%	36.7%	30.5%

(* includes land or quota leased out)

For these three years, the average figure for farm income as % of farm receipts is 33.7%. Each year the data would be updated, so that the "average" relates to the three most recent years for which NFS data is available.

In order to avoid a situation whereby a farmer on the full accounts-based system would use receipts for costs not incurred by him but incurred by a farmer on the Simplified system, a farmer on the Simplified system would be obliged to hold all farm records of sales and purchases for a period of 5 years, and could be subject to an Income Audit based on such records for a period of up to 5 years.

Example: Farmer A would submit records that for the most recent year he had total receipts of €30,000 (€22,000 net sales and €8,000 direct payments). Applying the coefficient of 33.7% to this gives a reckonable income of €10,110, on which he would make the Social Contribution.

3.4 Specific reform of the Income Tax system for farming

The Income Averaging system provides some accommodation for the problem that farm income can fluctuate substantially from year to year. However, the system is relatively complex where a farmer wishes to opt out of the system. Also, it can result in significant cash flow problems for farmers in years of declining profits.

An amended system of managing farm income volatility through the tax system may be required, and IFA will examine and bring forward proposals on alternatives.

In addition, it is proposed that the income tax system be amended to encourage farmers to increase production, output and exports, including, for example, an expansion of existing stock relief measures.

Appendix I Income Levies: Current Method of Income Assessment, Thresholds and Rates

The present system of "levies", i.e. PRSI contributions, Health Levy and Income Levy is extremely complex. First, the method of assessment of income differs; second, rates and thresholds differ, and third, there are different treatments between employees and self-employed. The following examines the Income Levies and Income Tax under a range of relevant headings, as a basis for IFA recommendations on the appropriate solution for a new broadly based social contribution.

1. Low Income Exclusion

	Income Tax	Employee PRSI*	Self-Employed PRSI	Health Levy	Income Levy
Excluded if income below	Yes (through credits)	€18,353/year (€352/ week)	€3,174 / year	€26,000 / year	€15,028 / year

(*Where liable to PRSI, a PRSI free allowance of €127/week (6,604/year applies for class A, i.e. Employee PRSI).

2. Income-related Age Exclusion

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy*
Aged 65 + Excluded if income below	€20,0000 (S) €40,0000 (M)	No	No	No	€20,0000 (S) €40,0000 (M)

(*If income above these levels, the income levy applies to total income)

3. Income Ceiling

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Income ceiling levy	No ceiling	€75,036 / year (4% rate)	No Ceiling (3% rate)	No ceiling	No ceiling

4. Rate of Levies

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy*	Income Levy
Rates of levy income bands	N.A	4% on income in range €18,353 - €75,036	3% on all income (if income over €3,174)	4% up to €75,036 5% on income over €75,036	2% up to €75,036. 4% for €75,036 – €174,980. 6% above that

(*: For self-employed, the 2010 Health Levy is 3.33% on all income up to €75,036, 4% on income from €75,036 to €100,100, and 4.167% on income over €100,100).

5. Exempt Income – Social Welfare payments

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Social Welfare exempt	No	Yes	Yes	Yes	Yes

6. Exempt Income – Income subject to DIRT

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Income subject to DIRT exempt	No (but 20% applies)	Yes	No	No	Yes

7. Exempt Income – Investment Income (e.g. Dividends)

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Investment Income exempt	No	Yes	No	No	No

8. Exempt Income – Occupational Pensions

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Occupational Pensions exempt	No	Yes	Yes	No	No

9. Deductible Item – Capital Allowances

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Capital allowances deductible	Yes	Yes	Yes	Yes	No

10. Deductible Item – Pension Contributions

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Pension contribution deductible	Yes	Yes	No	Employees: Yes Self-emp: No	No

11. Deductible Item – Trading Losses

	Income Tax	Employee PRSI	Self-Emp. PRSI	Health Levy	Income Levy
Trading losses deductible	Yes	NA	No	No	No