



No.375 / September 2011

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IIS Discussion Paper No. 375

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Corporation Tax: How Important is the 12.5 % Corporate Tax Rate in Ireland?

Working Paper¹

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There has been considerable recent controversy and complaints about the corporate tax rate in Ireland. For example that it is an unfair 'beggar thy neighbour' type policy; that it induces tax competition to the detriment of other countries in reducing their tax revenues; that Ireland needs tax, why not increase the corporate tax rate. The Financial Times (Peter Spiegel, 8, December) reports that opposition Social Democratic and left wing parties in Finland strongly opposed the EU/IMF fund for Ireland on the basis that the Irish corporate tax rate should be raised, although it was also reported that there was barely any objections to the fund in the Bundestag (Quentin Peel, Financial Times, 8, December). President Sarkozy in France is quoted as stating that Ireland cannot continue to benefit from financial aid from the European Union while maintaining a low corporate tax rate (Irish Times, January, 13, 2011). The German Government plan on economic governance within the Eurozone, (Der Spiegel, 2011), has four main strands one of which is to harmonize corporate tax rates and specifically refers to Ireland's low corporate tax rate. Media reports have suggested that reduction in interest rates on EU loans have been made conditional on changes in Ireland's corporate tax rate (Scally, et al, 2011).

These concerns predate the current economic crisis. The French Government supported a commission plan (European Commission, 2007) to introduce a Common Consolidated Tax Base (CCCB) during its six month presidency of the EU in 2008. The proposal was partly motivated by a desire to mitigate 'harmful tax competition'. In June 2007, the German Finance minister criticised tax reliefs available at the IFSC and argued that low tax reliefs in Ireland were an example of 'tax dumping' (Smyth, 2007).

The corporate tax rate in Ireland is often described at the 'cornerstone' of industrial policy. This paper argues that excessive reliance on tax

reliefs and on the attraction/retention of foreign direct investment has led to the development of certain tax haven type features for the Irish economy. Tax haven type features are in turn at variance with the development of sustainable firms.

The pre-eminence given to the corporate tax rate is also at variance with data on the distribution of tax rates amongst Irish firms discussed in the next section.

(1) The Distribution of Tax Rates

Table (1) shows that most companies in Ireland currently either pay no, or minimal corporate tax. If a company does not pay and does not expect to pay corporate tax, the tax rate is irrelevant². Hence a low corporate tax cannot be the 'cornerstone' of industrial policy. Most of these companies are likely to be small and indigenous. In contrast 428 companies paid 70% of corporate tax for 2008. These are likely to be foreign owned firms.

Table (1)
The Distribution of Corporation Tax Payments By Irish Companies in 2008

Net Trading Income € ¹	Number of Cases	Tax Paid € million	% of total tax	% of cases
≤ 0	17875	378	7.4	32.9
1 - 25,000	15979	29	0.6	29.4
25,000- 50,000	4883	30	0.6	9.0
≥ €10 m	428	3576	69.8	0.8

(1) Defined as trading profits from a company's accounts, plus expenses not allowable for tax, minus tax depreciation. To the extent that accounting depreciation is higher than tax depreciation, this figure will overstate pretax profits, and conversely.

Source: Revenue Commissioners, Corporation Tax Distribution Statistics, Table CTS1

Similar distributions can be found in other countries. For the UK for 2008-09, 0.67% of those companies who paid corporate tax accounted for 67% of tax payments (HMRC 2011, Table T 11.6). Tax payments are also concentrated by sector. Three sectors (Energy and water supply, Banking finance and Insurance and Business services account for 62 % of corporate tax paid (HMRC, Table T11.7). In 2006-07 700 firms covered by the Large Business Unit of HMRC paid 54% (£23.8 billion) of all corporate tax and 50 Businesses paid 67% of taxes collected by the Large Business Unit. While 220 business paid no Corporation Tax in 2005-06. For the period 2008-09, 51.7% of all UK

companies paid no corporation tax, and a further 23% paid under £5000. UK tax data also shows some persistence over time in tax payments, 77% of UK based companies that paid no tax in 2008-09, also paid no tax in 2007-08.

(2) How Important are Corporate Tax payments?

Even though the corporate tax rate is low in Ireland, as shown in Table (2) corporate tax payments as a % of total tax revenue are higher than for many other EU countries, for example France and Germany.

Table (2)
Corporate tax payments as a % of Total Tax Payments

Country	1980	1985	1990	1995	2005	2007	2008
Ireland	4.5	3.2	5.0	8.5	11.2	10.9	9.7
UK	8.4	12.6	9.9	8.1	9.3	9.4	10.0
France	5.1	4.5	5.3	4.9	5.5	6.8	6.7
Germany	5.5	6.1	4.8	2.8	4.9	6.1	5.1
Netherlands							
EU 19	5.7	6.3	6.7	7.0	8.5	9.1	8.2
OECD	7.6	8.0	8.0	8.0	10.3	10.8	10.1

Source: Revenue Statistics 2005-2008, Table 13, OECD 2010 and 2009.

Corporate tax payments as a % of total tax revenues are higher in Ireland than many other EU countries because foreign owned companies are highly profitable in Ireland, because profits are “switched to Ireland” via transfer pricing (Stewart, 1989). This occurs not just because of a low tax rate, but because of other factors such as a network of double tax treaties, a corporate tax regime that is very responsive to demands from existing and potential foreign investors, and ease of incorporation. These features are shared by tax havens and low tax jurisdictions. One implication is that increasing corporate tax rates may have the effect of reducing tax payments in Ireland because of reduced incentives to switch profits to Ireland. The opposite to what has been argued by some (Smaghi, 2011).

(3) What is the Effective Tax Rate in Ireland?

Calculating an effective tax rate for a single country is complex. Calculating comparable effective tax rates across a number of countries more so. One such study that attempts to do this is the much cited PWC/IFC Report (Paying Taxes 2011, the Global Position). This report found the effective rate of tax on corporate profits in

Ireland to be 11.9% (p. 98), and 8.2% in France (p. 99). However the PWC/IFC data cannot be relied on to estimate effective tax rates because it is based, not on real data, but on a "standard firm with 60 employees", a standard size (102 times income per capita PWC/IFC, p. 8), and a fixed gross profit margin of 20% (p. 13). Existing nominal tax rates are then applied in estimating tax paid etc. This means that estimated tax rates apply to small companies employing less than 50 and with capital employed of under €3 million. Interpreting such results can be difficult given that many countries have low tax rates for small firms, for example 15% in France. A new incorporated entity in Ireland is exempt from corporation tax for the first three years.

Effective tax rates can be measured as cash tax paid/ profits before tax allowances. This measure can be derived from company accounts as tax paid/(pre-tax profits plus provision for depreciation). Accounting depreciation is included in the tax base, because it is not a tax deductible expense in contrast to accelerated depreciation allowances, or allowances for expenditure on R. and D. Another measure is tax paid/pre-tax profits. Individual examples of low effective tax rates are not difficult to find. Table (3) gives some examples using both tax bases as a measure. The tax rates are derived from accounts of individual subsidiaries. As a result some of the reported profit and tax paid is outside Ireland. A similar low rate can be found for some Irish companies as well. For example Ryan Air had an effective tax rate of 7% for the three years ending March 2009, and Grafton Group 4.2%, for the three years ending December 2009.

Table (3)

Effective Tax Rate for Selected MNC Subsidiaries Operating in Ireland

\$'million.

	Turnover	Pre-tax Profit P	Accounting Depreciation/ Amortization D	Tax T	Effective Tax Rate (1) P/T	Effective Tax Rate (2) T/(P+D)
Boston Scientific ¹ (2001-03)	1243	769	1.66	4.15	0.54	0.538
Forest laboratories (2005-07)	4755	1618.1	44.11	100.9	6.2	6.1
Symantic (2004-5) ²	275.1	275.1	0.10	0	0	0

(1) 'The principal activity of this subsidiary is the holding of shares in other companies and related intellectual property for which it receives royalties'.

(2) The principal activity is described as "investment and intellectual property holding".

Data produced by the US Bureau of Economic Analysis (BEA) relating to US companies operating abroad shows a very different picture from that in the PWC/IFC Report. Table (4) shows a measure of effective tax rates defined as tax paid/net income. The data refers to aggregate taxes paid and aggregate profits. The data is based on income declared in each country, so that for Luxembourg and the Netherlands, most income relates to investment income. Table (4) shows effective tax rates of 4.2% in Ireland compared with 26.8% in France. This compares with a nominal rate of 33.3% in France.

Excluding investment income (Table 5) would result in a higher effective tax rate, for example the effective tax rate for Ireland would increase from 5.3% to 8% for 2007. The vast proportion of income of US companies reported in tax haven type countries is derived from income from equity investments. For 2008 this varies from 66% in the UK Caribbean Islands, to over 100% in the case of Luxembourg. In the case of income from equity investment, tax may already have been paid or the income is exempt from corporate tax. In contrast income from equity investments for US firms is far lower in Ireland (under 50%) and is similar as a proportion of net income to countries such as France and Germany.

Table (4)
Net Income and Tax Paid of US Companies in Ireland and Other Countries
\$ Million¹

	2006	2006	2006	2007	2007	2007	2008	2008	2008
	Net Income	Foreign Income Tax	Tax Rate	Net Income	Foreign Income Tax	Tax Rate	Net Income	Foreign Income Tax	Tax Rate
Netherlands	89,680	3,990	4.4	106,681	2,639	2.5	139,344	2,971	4.1
Luxembourg	56,840	572	1.0	60,561	496	0.8	90,466	382	0.4
Ireland	46,887	2,508	5.3	65,711	3,492	5.3	80,415	3,386	4.2
Bermuda	52,232	604	1.2	70,499	387	0.5	64,592	400	0.6
Switzerland	44,460	1,574	3.5	48,856	1,655	3.4	53,060	1,882	3.5
UK Islands Caribbean	22,282	355	1.6	38,719	679	1.6	48,605	486	1.0
France	7,662	2,783	36.0	11,189	3,556	31.8	12,386	3,326	26.8
Germany	14,648	4,200	28.7	17,470	6,652	38.0	20,287	4,387	21.6
UK	55,807	16,909	30.3	24,553	13,325	54.3	3,103 ²	13,202	----
Total Worldwide	667,349	114,027	17.1	766,006	125,181	16.3	872,506	143,893	16.5

(1) The data excludes banks. Source: Majority-Owned NonBank Foreign Affiliates of Nonbank U.S. Parents, Table III.E.1. In Ireland for 2008 there were 560 nonbank affiliates employing 91,000. This is lower than IDA estimates, hence it may be the case that in this data some US owned firms are omitted because for example, they are organised as a branch of a Dutch parent company and location has been assigned to the Netherlands (Stewart, 2006).

(2) After reporting capital losses of \$23,487 million

Table (4) shows that six countries with tax haven/low tax features account for over 60% of global U.S. profits. The Netherlands and Luxembourg are the largest 'tax havens' in the world for U.S. investment.

There is another alternative measure of the profits of US Affiliates abroad described as a "profit type measure". The approximate same estimate of profit is obtained if income from equity investments is deducted from the estimate of net income shown in Table (5). This estimate of profits is used by Sullivan, (2010) who presented evidence on the effects of transfer pricing to the US Congress (August 2, 2010).

If this measure of profits is used, US affiliates earn more profits in absolute terms in Ireland than any other country in the world. The effective tax rate in Ireland is the lowest in the EU area at 7.3%. The effective tax rate for France is 37%. It is also interesting to note that this measure grossly understates the role of the Netherlands and Luxembourg as conduits for financial flows for US multinational companies.

Table (5)
Profit and Tax Rates of US Companies in Ireland and Other Countries
\$ Million¹

	2006	2006	2007	2007	2008 ²	2008
	Profit – Type Return	Tax Rate	Profit – Type Return	Tax Rate	Profit – Type Return	Tax Rate
Netherlands	8,430	47.3	8,651	30.5	9,763	30.4
Luxembourg	-2,168		-1,170		-2,819	
Ireland	37,885	6.6	47,320	7.4	46,077	7.3
Bermuda	10,471	5.8	10,471	3.7	11,651	3.4
Switzerland	15,515	10.1	15,515	10.7	16,428	11.4
UK Islands Caribbean	7,511	4.7	7,511	9.0	7,750	6.2
France	9,042	30.8	9,042	39.3	8993	37
Germany	13,597	30.9	13,597	48.9	13449	32
UK	33,299	50.8	33,299	40.0	35,162	37.5
Total Worldwide	419,550	27.1	419,550	29.8	466970	30.8

(1) The data refers to majority owned non-bank affiliates of non-bank US parents. The data for profits is described as a 'profit-type return'. Source: US Bureau of Economic Analysis, U.S. Direct Investment Abroad, Table III.G7.

(2) Preliminary Statistics

The BEA data has been criticised because “it appears to include companies that are registered in Ireland but not resident for tax purposes” (Walsh , p. 25). This may explain the lower corporation tax payments identified in revenue statistics compared with US data. However including US firms which are not tax resident may not make much difference to average effective tax payments if the size of tax payments and profits reported by such firms is small, or if their effective tax rate is close to the average. At the same time employment reported by BEA data (91,000) is close to that reported by the IDA (94,000) for US supported firms in Ireland. BEA data excludes banking firms which may account for some of the difference. Hence if non-resident firms are included in US data they are unlikely to account for more than 5% of total US employment.

Aggregate data for US subsidiaries may not indicate national average effective tax rates. There is often a large gap between nominal tax rates and effective tax rates, for example of 700 companies in the Large Business Service unit of the UK revenue authorities (HMRC), 28% paid no corporation tax in 2006-06 (National Audit Office, 2007, p. 10). Many of the 500 companies in the Standard and Poor index in the US pay far less than the standard tax rate of 35% (Leonhardt, 2011).

(4) How important are low corporate tax rates in attracting Multinational investment to Ireland?

The answer to this question in Ireland is almost unanimous, and that is, it is vital. However some survey evidence indicates that tax is not the most important factor in influencing investment decisions. One source of survey data has been provided by Ernst & Young since 1997 and claims to be based on contacts with 70% of companies undertaking investment (Ernst & Young 2010, p. 45). The Ernst and Young Survey for 2010 found that the “the best way for states to stimulate future European attractiveness is (with per cent of respondents in brackets):-

- (1) to support small and medium sized enterprises (29%);
- (2) support high-tech industries and innovation (27%);
- (3) reduce taxation and increase flexibility (22%).

Reducing taxes was found to be the third most significant factor, this was true for just 22% of respondents. This is because for different sectors different factors will be important. The 2009 survey (Ernst & Young, 2009, p. 7) found that companies providing business to business services reported that telecommunications infrastructure was very important (61.5%). The next most important factor was labour skills (53%).

Various econometric studies which examines the relationship between tax and FDI report that non-tax variables show stronger results (more statistically significant results) than the tax rate (Varley 2007). Varley concludes (p. 35) that the studies reviewed are consistent with results from surveys, that is market size, distance to market, and wage costs are more important than tax rates influencing investment.

How may this evidence be reconciled with statements from the American Chamber of Commerce and others? Ireland may attract companies for which low tax is important. But in order for low tax rates to be of value they must be matched by other factors - the legal environment including regulation, double tax treaties, ease of incorporation, and the ability to fit Irish operations into a coherent group tax and financing strategy. In addition foreign investment located in Ireland often also stresses other factors such as wage rates (see Stewart, 2005, for a further discussion).

Tax rates may be very important for some companies. But the more dependent a company is on low corporate tax rates, the more ‘footloose’ the company. The greater the importance of tax factors the

less likely they are to have linkages with local firms, - the degree of embeddedness will be much lower. Factors identified by Ernst & Young such as a skilled work force, nearness to market, logistics, telecommunications, will be less relevant.

Tax dependent firms are vulnerable to relocation/shut down because of product obsolescence, rising wage costs compared with low cost wages in eastern Europe, and China. Those firms that have no real presence here are the most vulnerable to relocation. A change in their tax status could emerge not because of changes in the Irish tax regime but because of changes in the source country for example, the US or the UK.

Pure tax haven type operations may create difficulties for other jurisdictions negotiating with their own MNC's such as the UK, they create little employment, tax revenues may be increased but may lead to considerable risks such as reputational risk – for example the description of Dublin as Lichtenstein on the Liffey in relation to group headquarter companies moving to Ireland from the UK (Guardian Newspaper, 2nd October, 2009).

Corporate tax is not and cannot be the “cornerstone of industrial policy” –competitiveness factors such as telecommunications, infrastructure, logistics and a skilled labour force are the really important issues.

Ireland has had preferential tax rates for over 50 years, initially for exporting firms, then manufacturing firms and more recently all incorporated entities, yet has failed to develop a strong indigenous base, or a national system of innovation. Multinational firms come and go, in some cases leaving little trace (Some example: Lanaknit, Ferenka, Fruit of the Loom). However some closures left a residue of skilled employees managers which went on to establish and work in other business for example, Digital Equipment Corporation.

Current industrial policy in Ireland is largely thought of in terms of tax reliefs. The stated purpose of Building Irelands Smart Economy (2007) was to develop “an exemplary research, innovation and commercialisation ecosystem”. In addition to other factors, this was to be achieved by introducing 16 new or extended tax reliefs. A tax based industrial policy will not result in an innovative, research led economy. A tax based industrial policy leads to an emphasis on tax reduction³. Those skilled in knowledge of the tax system become senior management (In 2009, 8109, or 66% of all qualified chartered

accountants were employed in business, Source: Chartered Accountants Ireland, 2009, p.7) . In turn their skills require constant updating and they become dependent on tax advisors. Those firms skilled in understanding the tax system and selling tax services become large and powerful. The dominance of accounting/taxation specialists in senior managerial positions is at the expense of those skilled in new product development, production expertise, logistics, and marketing.

Economic success in Ireland, as in the case with other 'tax-haven countries, or countries with tax haven type features of which a low corporate tax rate is an essential feature will not result in long run economic success (Shaxson).

(5) Conclusion

In conclusion a low corporate tax rate in Ireland cannot be "the cornerstone of industrial policy" because most companies pay little or no corporate tax because they have no or low taxable profits. Many of these are likely to be small indigenous firms. Many other firms that pay tax have an effective tax rate below the nominal tax rate.

Footnotes

(1) This paper was sent as a submission to H.M. Treasury, on Rebalancing the Northern Ireland economy, HM Treasury, March 2011.

(2) Granting fiscal incentives to companies that are tax exhausted poses a policy dilemma. One solution in Ireland in relation to R and D tax credits is to return excess tax allowances as cash (Department of Finance, Dublin, Review of Tax Expenditures, p. 76). An alternative is to allow companies to offset the R and D credit against employers PRSI (New Programme for Government, p. 9)

(3) Tax minimisation can become a major aspect of a firm's operations, so that tax departments become viewed as a 'profit centre' (Kocieniewski, 2011). Tax minimisation is regarded as being so important to General Electric that tax strategists have been placed in key managerial positions (Kocieniewski, 2011).

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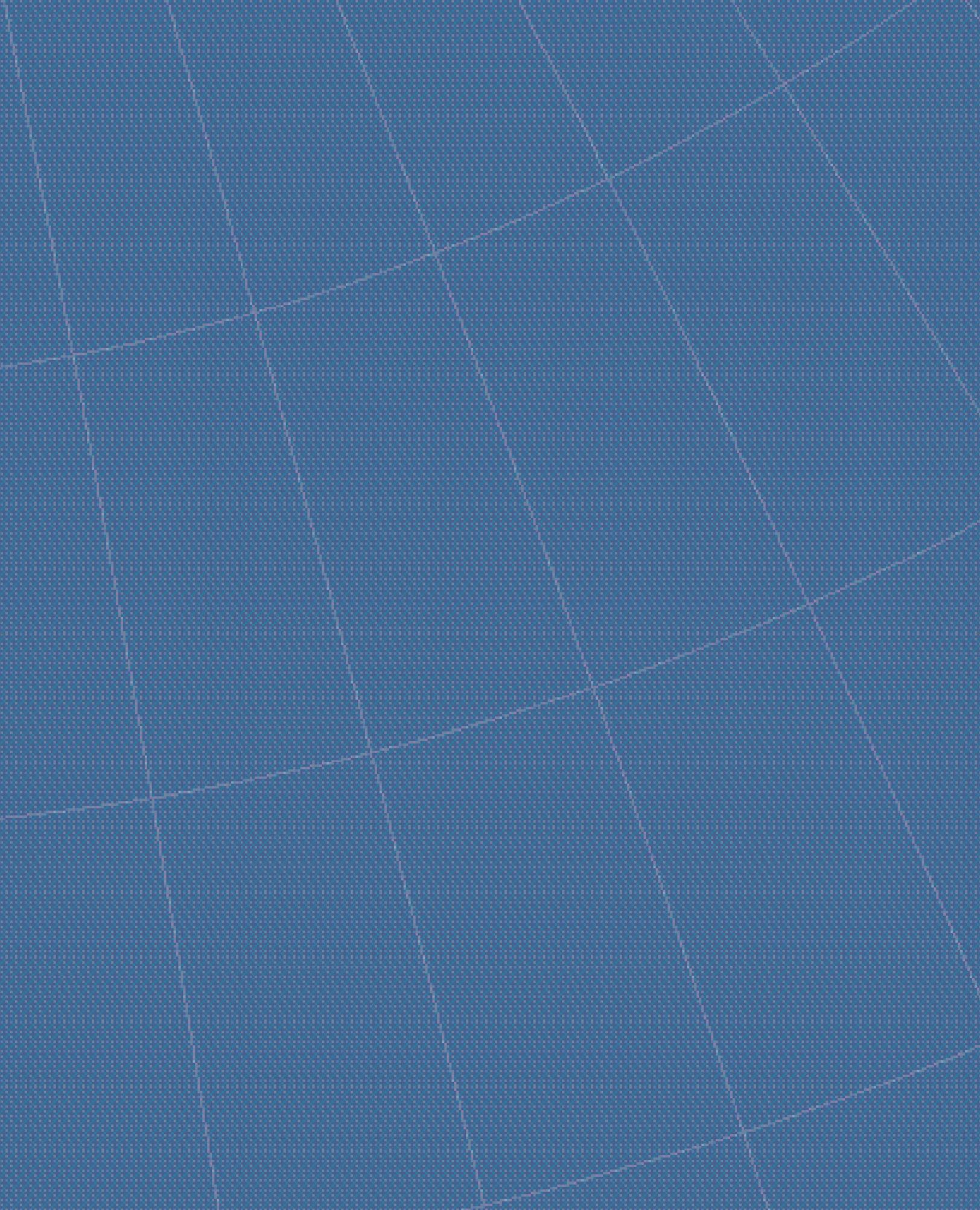
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