Guidance on Restriction of Reliefs for High Earners and Related Issues: 2013 Tax Filing

Marie Bradley *Principal, Bradley Tax Consulting*

Introduction

The high-earner restriction has been with us since 2007, but its impact has really been felt from 2010 onward, when the scope of the restriction was widened. This article explains the relevant legislation and, with the aid of detailed examples, shows how the restriction works.

What Is the Restriction Trying to Achieve?

The objective of the legislation when it was introduced in Finance Act 2006 was to ensure that "high" earners who availed of various tax reliefs and exemptions would pay an effective rate of tax of at least 20%. Finance Act 2010 amended the legislation and increased the minimum effective rate of tax to 30%. From 2010, the restriction applies to a far greater number of taxpayers.

Relevant Legislation

The relevant legislation is set out in ss485C to 485G TCA 1997:

- Section 485C defines the various terms used in s485D.
- Section 485D sets out the rules that are to be applied in determining whether the restriction applies to an individual for a particular tax year.
- If the restriction applies, s485E sets out how the individual's taxable income is recalculated, and s485F deals with the carry-forward of the reliefs that were not used as a result of the restriction having applied.
- Section 485FA adapts certain sections of the legislation applicable to married couples and civil partners who are jointly or separately assessed where one or both of the

individuals is/are subject to the high-earner restriction. The spouse or civil partner is considered separately when assessing whether and to what extent the restriction applies to that individual.

- Section 485FB requires individuals who are subject to the restriction to make a self-assessment return for that tax year and to provide details of how the restriction has been calculated (Form RR1).
- Section 485G deals with miscellaneous matters in relation to the operation of the restriction.

Does the Restriction Apply?

First, it is necessary to determine whether the restriction applies at all. This involves a number of steps. The table below is based on the Finance Act 2010 legislation.

Step 1	Calculate **taxable income** in the normal way, ignoring the restriction (**T**).
Step 2	Identify any **ring-fenced income** (**R**).
Step 3	Identify the **aggregate of the specified reliefs** used in the calculation of taxable income (**S**).
Step 4	Calculate **adjusted income** (**A**): A = T + S – R
Step 5	Calculate the **income threshold amount.** The income threshold amount is either: (i) €125,000 or (ii) where A < €400,000 and there is ring-fenced income, €125,000 x A/(T + S).
Step 6	Consider the following three questions. **Question 1**: Is A greater than or equal to the income threshold amount? **Question 2**: Is S greater than or equal to the relief threshold amount of €80,000? **Question 3**: Is 20% of A less than S? If the answer to all three questions is “yes”, the restriction applies for that tax year. If the answer to one or more of the questions is “no”, the restriction does **not** apply for that tax year.

Recalculated Taxable Income

If the restriction applies, it is necessary to increase the individual’s taxable income using the following formula set out in s485E:

Recalculated taxable income = T + S – Y

where Y = the greater of:

(a) the relief threshold amount of €80,000 and

(b) 20% of A.

Therefore, if the individual’s adjusted income exceeds €400,000, specified reliefs equal to 20% of adjusted income may be deducted in arriving at taxable income. This should have the effect of achieving a minimum effective rate of tax of 30%. However, if the individual’s adjusted income is less than €400,000, the deduction for specified reliefs is set at €80,000. Although this should increase the effective rate of tax paid by the individual, the effective rate may be lower than 30%.

Carry-Forward of Excess Relief

The amount of specified reliefs that have been added back in arriving at the recalculated taxable income is carried forward under s485F as “excess relief” for offset against total income in subsequent tax years. Excess relief is treated as a specified relief and may be offset in the following year only **after** relief has been given for any other tax relief available.

It is worth noting that reliefs carried forward as excess relief lose their character, and therefore excess relief should not be subject to the “guillotine” provisions of s409G, which will be effective from 1 January 2015 in certain cases.

Excess relief is lost on death. Likewise, other specified reliefs, such as accelerated Case V capital allowances, that are unused as a result of the individual having insufficient income are lost on death, with the possible exception of s23-type relief where the spouse of the deceased inherits the property.

Meaning of “Ring-Fenced Income” and “Specified Reliefs”

Ring-fenced income

Ring-fenced income (R) includes:

- Irish deposit interest that suffered DIRT (deposit interest retention tax);

- Irish deposit interest received gross because the individual made a declaration that he or she was either over 65 or permanently incapacitated;
- deposit interest received gross arising in another EU Member State and that is liable to tax in Ireland at a rate equal to the DIRT rate;
- payments and gains relating to certain foreign life policies; and
- payments and gains relating to certain offshore funds.

Aggregate of the specified reliefs used

The aggregate of the specified reliefs used (S) is the specified reliefs that would have been deductible in arriving at the individual's taxable income if the restriction was ignored. The full list of specified reliefs is set out in Schedule 25B. It includes items such as accelerated capital allowances, s23-type relief, s50-type relief in respect of student accommodation and film relief. In addition, it includes certain exempt income such as income within the scope of the artists' exemption.

Some items that are not included are:

- medical expenses, pension contributions and personal tax credits;
- capital allowances on plant and machinery, with the exception of capital allowances on certain plant and machinery claimed by passive investors in a leasing trade;
- normal business expenses;
- losses of a trade;
- rental losses, except where those losses relate to a deduction for s23-type or s50-type relief;
- relief under a double taxation agreement;
- although tax relief claimed under the Employment and Investment Incentive Scheme is a specified relief, Finance (No. 2) Act 2013 amended the legislation so that the relief will not be regarded as a specified relief where the subscription for eligible shares under the scheme is made during the period from 16 October 2013 to 31 December 2016.

The definition of the "aggregate of the specified property reliefs" is relevant to the calculation of the 5% property relief surcharge that is collected as additional USC under s531AAE. The 5% property relief surcharge applies where the individual's aggregate income, as defined for USC purposes, for the tax year amounts to €100,000 or more and the individual uses specified property reliefs in the calculation of his or her taxable income for that tax year. The surcharge is calculated by reference to the aggregate of the specified property reliefs used in the tax year. Revenue's view, as set out in "Part 18D-06-01. Universal Social Charge: Property Relief Surcharge" of its tax and duty manuals, is that the surcharge applies to the specified property reliefs that would have been deductible in arriving at the individual's taxable income if the restriction were ignored. This is illustrated in Example 1.

Example 1

Alison is self-employed. Her tax-adjusted trading income for 2013 was €305,000. She owns a number of rental properties. Profit rent for 2013 was €95,000. She was also in receipt of gross deposit interest of €5,000 (on which DIRT was deducted). Excess relief carried forward at 1 January 2013 amounted to €330,000. She also had unused Case V nursing home capital allowances of €150,000 at 1 January 2013 as a result of having insufficient rental income in previous tax years. The nursing home was first put into use on 1 December 2006.

Step 1*: Calculate* ***taxable income*** *in the normal way, ignoring the restriction (****T****).*

Alison's taxable income for 2013, ignoring the restriction, is calculated as follows:

	€	€
Case I income		*305,000*
Case IV income		*5,000*
Case V income	*95,000*	
Case V capital allowances carried forward	*(95,000)*	*Nil*
		310,000
Excess relief		*(310,000)*
Taxable income (T)		*Nil*

Step 2*: Identify any* ***ring-fenced income*** *(****R****).*

Ring-fenced income amounts to €5,000.

Step 3*: Identify the* ***aggregate of the specified reliefs*** *used in the calculation of taxable income (****S****).*

	€
Case V capital allowances used	*95,000*
Excess relief used	*310,000*
Aggregate of specified reliefs used (S)	*405,000*

Step 4*: Calculate* ***adjusted income*** *(****A****):*

A = T + S – R

	€
Taxable income (T)	*Nil*
Aggregate of specified reliefs used (S)	*405,000*
Ring-fenced income (R)	*(5,000)*
Adjusted income (A)	*400,000*

Step 5*: Calculate the* ***income threshold amount****.*

The income threshold amount is either:

(i) €125,000 or

(ii) where A < €400,000 and there is ring-fenced income, €125,000 x A/(T + S).

As adjusted income (A) = €400,000, the income threshold amount is €125,000.

Step 6*: Consider the following three questions.*

Question 1*: Is A [€400,000] greater than or equal to the income threshold amount [€125,000]?* ***Yes***

Question 2*: Is S [€405,000] greater than or equal to the relief threshold amount of €80,000?* ***Yes***

Question 3*: Is 20% of A [€80,000] less than S [€405,000]?* ***Yes***

As the answer to all three questions is "yes", the restriction applies.

Therefore, it is necessary to recalculate Alison's taxable income as follows:

Recalculated taxable income = T [€Nil] + S [€405,000] – Y [€80,000]

= €325,000

Excess relief (2013) = €325,000 (S – Y)

Excess relief available for carry-forward to 2014 is calculated as follows:

	€
Excess relief carried forward at 1 January 2013	*330,000*
Used against total income in 2013 (before applying the restriction)	*310,000*
	20,000
Excess relief – 2013	*325,000*
Excess relief carried forward at 1 January 2014	*345,000*

In addition, Alison has unused Case V capital allowances of €55,000 (€150,000 less €95,000 offset against rental income in 2013). As the tax life of the nursing home, as defined in s409F and s272(4)(f)(i), ended in 2013, any of those carried forward Case V capital allowances that are not used against Alison's rental income in 2014 will be lost (s409G). The tax life ended in 2013, notwithstanding that the holding period referred to in s274(1)(b)(iia)(I) will not end until December 2016.

Alison is also liable to the 5% property relief surcharge calculated by reference to the Case V nursing home capital allowances used in calculating her taxable income before applying the high-earner restriction (€95,000), as opposed to the specified reliefs allowed (€80,000) in arriving at her recalculated taxable income. This results in a 5% property relief surcharge for Alison for 2013 of €4,750 (€95,000 x 5%).

Example 2

John owns a number of rental properties, which he purchased over the years. Profit rent for 2013 amounted to €125,000. This was his only source of income in 2013. He had unused s23 relief carried forward at 1 January 2013 of €100,000. John was not affected by the high-earner restriction in prior tax years.

Step 1*: Calculate* ***taxable income*** *in the normal way, ignoring the restriction (****T****).*

John's taxable income for 2013, ignoring the restriction, is calculated as follows:

	€
Case V income	*125,000*
Section 23 relief	*(100,000)*
Taxable income (T)	*25,000*

***Step 2**: Identify any **ring-fenced income** (**R**).*

John has no ring-fenced income.

***Step 3**: Identify the **aggregate of the specified reliefs** used in the calculation of taxable income (**S**).*

	€
Section 23 relief used	*(100,000)*
Aggregate of specified reliefs used (S)	*100,000*

***Step 4**: Calculate **adjusted income** (**A**):*

$A = T + S - R$

	€
Taxable income (T)	*25,000*
Aggregate of specified reliefs used (S)	*100,000*
Ring-fenced income (R)	*(Nil)*
Adjusted income (A)	*125,000*

***Step 5**: Calculate the **income threshold amount**.*

The income threshold amount is either:

(i) €125,000 or

(ii) where A < €400,000 and there is ring-fenced income, €125,000 x A/(T + S).

As there is no ring-fenced income, the income threshold amount is €125,000.

***Step 6**: Consider the following three questions.*

Question 1**: Is A [€125,000] greater than or equal to the income threshold amount [€125,000]? **Yes

Question 2**: Is S [€100,000] greater than or equal to the relief threshold amount of €80,000? **Yes

Question 3**: Is 20% of A [€25,000] less than S [€100,000]? **Yes

As the answer to all three questions is "yes", the restriction applies.

John's recalculated taxable income amounts to €45,000 (T [€25,000] + S [€100,000] – Y [€80,000]). Therefore, excess relief carried forward to 2014 amounts to €20,000 (S [€100,000] – Y [€80,000]).

John is also liable to the 5% property relief surcharge based on the s23 relief used in calculating his taxable income for 2013, resulting in a liability of €5,000 (€100,000 x 5%).

It is worth noting that if John's profit rent for 2013 amounted to €124,999, John would not be subject to the high-earner restriction for 2013 as his adjusted income (€124,999) would be less than €125,000 (i.e. the answer to Question 1 would be "no"), and therefore John would be allowed to deduct the full amount of the available s23 relief of €100,000 in calculating his taxable income of €25,000. John's 5% property relief surcharge liability would still amount to €5,000.

Related Issues

- Although the individual's income tax liability is based on taxable income (or recalculated taxable income if the restriction applies), it is necessary to consider separately to what extent the reliefs that have been availed of are deductible for the purposes of calculating the individual's USC and PRSI liabilities.
- Section 485C(3) sets out the order of priority between specified reliefs and other reliefs where the method of giving relief is the same:
  - Relief is to be given in respect of capital allowances that are not specified reliefs in priority to capital allowances that are specified reliefs. This rule applies regardless of whether the individual is subject to the high-earner restriction for that tax year.
  - Normal Case V deductions are deducted from gross rent in priority to a specified relief such as s23 relief.
  - Non-specified reliefs, such as health expenses, are deducted from total income in priority to specified reliefs.

- › Relief is given for a loss that is not referable to the use of a specified relief in priority to a loss that is referable to the use of a specified relief.
- › Normal Case I/II business expenses are deducted in priority to double rent relief.

- › Where a building that qualified for capital allowances is sold, and there are unused capital allowances carried forward from earlier years in respect of that building (which have not become excess relief), the use of those capital allowances to reduce a balancing charge on the sale of the building will not be treated as a specified relief for the purposes of the restriction (s485C(1A)).
- › Although s485G(2)(a)(iii) provides that the balancing allowance or balancing charge arising on the sale of a building that qualified for capital allowances should be calculated in the normal way, ignoring the restriction, it allows a balancing charge to be reduced if there is excess relief carried forward from an earlier year. The formula for calculating the reduction is set out in s485G(2)(b).

Example 3

Using the facts set out in Example 1, assume that the nursing home is sold on 1 January 2014 for €9.5m. Alison is a member of a consortium of investors who purchased the newly constructed nursing home in 2006. Alison owns 10% of the nursing home. The tax-written-down value of the nursing home at 1 January 2014 was €Nil. Alison claimed nursing home capital allowances totalling €1.1m over the tax years 2006 to 2012 inclusive. Alison has excess relief carried forward at 1 January 2014 of €345,000 and unused Case V nursing home capital allowances of €55,000.

In the absence of the relieving provisions of s485C(1A) and 485G(2)(a)(iii), Alison would have a balancing charge of €950,000. Although Alison would seek to deduct the carried-forward nursing home capital allowances and excess relief from the balancing charge when calculating her income tax liability for 2014, in the absence of any relieving measures, the operation of the high-earner restriction in 2014 would limit the deduction.

Section 485C(1A) allows Alison to deduct the carried-forward nursing home capital allowances of €55,000 from the balancing charge. The €55,000 deduction is not treated as a specified relief. Furthermore, the €55,000 deduction is not taken into account for the purposes of computing Alison's adjusted income for 2014. Therefore, the operation of the high-earner restriction in 2014 should not cause the €55,000 deduction to be added back in Alison's income tax computation.

Furthermore, s485G(2)(a)(iii) allows the balancing charge to be reduced by some or possibly all of the excess relief carried forward to 2014 (€345,000) that is not otherwise used in 2014. The amount of the reduction is set out in s485G(2)(b).

Conclusion

Although the restriction of reliefs for high earners has been with us since 2007, the changes that took effect in 2010 have meant that most tax practitioners have to consider the potential impact of the restriction on a number of their clients. The calculations may be relatively straightforward on the face of it, but the various definitions set out in the legislation, the provisions with regard to the order of reliefs etc. can complicate matters. We understand that the Revenue Commissioners are checking high-earner restriction calculations submitted in prior years. Therefore, it is worthwhile carrying out a self-review of calculations submitted to Revenue to identify any issues.

Furthermore, as the "guillotine" provisions of s409G will prohibit an individual from carrying forward unused capital allowances beyond 31 December 2014 where the tax life of the building has expired, it will be necessary to analyse the make-up of carried-forward reliefs to determine the extent to which those provisions will erode that pool of reliefs.

Read more on TaxFind *Taxation Summary*; *Capital Allowances and & Property Incentives*; *FINAK – Finance (No. 2) Act 2013 Explained*; *Direct Tax Acts, Finance (No. 2) Act 2013*