Committee on Budgetary Oversight

Report on Tax Expenditures: Research & Development Tax Credit and Knowledge Development Box

September 2022
COMMITTEE MEMBERSHIP

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CATHAOIRLEACH’S FOREWORD

Tax expenditures play a significant role in our taxation system and help to support both people and businesses through a variety of means, ranging from benefits-in-kind such as tax relief on commuter tickets, reliefs in health expenses through personal tax credits, to corporation tax relief through the Research and Development Tax Credit. Not only do they play a significant role in supporting people and businesses, but they can also serve to facilitate and incentivise innovation and encourage entrepreneurial business growth.

However, as tax expenditures represent a reduction in tax revenues which would otherwise accrue to the State, it is important that they be scrutinised to ensure they are achieving the objectives they are designed to and that they are fit for purpose. This is particularly important in light of the fact that the most recent estimate of the total revenue forgone through tax expenditures amount to at least €7.1 billion and if this was to be spent through voted expenditure it would be the fourth biggest vote group, after Social Protection, the Health Group and Education.

For the purposes of this report the Committee has focused on both the Research and Development Tax Credit and the Knowledge Development Box, both tax expenditures that are designed to add value to the Irish economy through incentivising research and development and the development of intellectual property.

The Committee has made a number of recommendations that we hope will contribute to the ongoing scrutiny of tax expenditures and help to improve the effectiveness of both the R&D Tax Credit and the Knowledge Development Box.

I would like to sincerely thank the officials from the Department of Finance, the Department of Public Expenditure and Reform, and the Revenue Commissioners for their engagement with the Committee. We look forward to further engagement on this topic in the future.
I would also like to thank the Members for their attention and cooperation in scrutinising this important issue, and the secretariat for their assistance in preparing this report.

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Neasa Hourigan TD.

Committee Cathaoirleach
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SUMMARY OF RECOMMENDATIONS

1. The Committee recommends that the Department of Finance and Revenue Commissioners agree a definition and publish a common list of tax expenditures.

2. The Committee recommends that the Department of Finance engage with the Department of Public Expenditure and Reform to recruit the appropriate number of staff and resources necessary to review the number of tax expenditures, as required under Department of Finance guidelines.

3. The Committee recommends that the Department of Finance prioritise the development of the R&D tax credit to enable small and medium enterprises to avail of an increased R&D credit of 30%.

4. The Committee recommends that the Department of Finance prioritise the introduction and implementation of a simplified approval procedure for the R&D tax credit for SMEs.

5. The Committee recommends that the Department of Finance prioritise awareness-raising of the R&D credit for SMEs.

6. The Committee recommends that the Department of Finance review the KDB in light of the possible impact of the OECD BEPS initiative.

7. The Committee recommends that the Department of Finance should consider extending the KDB credit to 2024 until there is further clarity on the impact of the OECD BEPS initiative.
INTRODUCTION

The Select Committee on Budgetary Oversight’s (the Committee) Interim Pre-Budget 2022 Report\(^1\) contained a section on tax expenditures and committed to examining tax expenditures on a regular basis. Following on from this, the Committee decided that in advance of Budget 2022 it would examine the Research and Development Tax Credit and the Knowledge Development Box.

The Committee has also begun examining the Film Credit and intends to produce a report following further engagement.

WHAT IS A TAX EXPENDITURE?

Tax expenditures are defined in Irish legislation through S.I. No. 508/2013 as:

> “tax expenditures” means a transfer of public resources that is achieved by—

(a) reducing tax obligations with respect to a benchmark tax rather than by direct expenditure, or

(b) provisions of tax legislation that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to the tax base.

The Department of Finance outlined that this definition draws on an OECD definition.

As of Budget 2022, there were 180 tax expenditures considered, with an estimated total cost €7.1 billion (with data unavailable for 13)\(^2\).

In discussing what constitutes a tax expenditure the Committee notes that there is some ambiguity between what constitutes those tax expenditures as published by the Department of Finance, and those tax expenditures published by the Office of Revenue Commissioners. In this regard the Department advised that the list published by Revenue\(^3\) is not based on the above OECD definition and includes

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\(^2\) Budget 2022: Report on Tax expenditures

\(^3\) Costs of tax expenditures (credits, allowances and reliefs)
some elements the Department of Finance do not regard as tax expenditures as they are considered to be part of the benchmark tax system.

Table 2: Top ten tax expenditures by cost

<table>
<thead>
<tr>
<th>Tax Expenditure</th>
<th>Value €m</th>
<th>Tax Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excise Rate on Kerosene</td>
<td>€680.9</td>
<td>Excise Duty</td>
</tr>
<tr>
<td>Employees’ contribution to approved superannuation schemes</td>
<td>€677.7</td>
<td>Pensions</td>
</tr>
<tr>
<td>Exemption of employers’ contributions from employee BIK</td>
<td>€658.3</td>
<td>Pensions</td>
</tr>
<tr>
<td>Research &amp; Development (R&amp;D) Tax Credit</td>
<td>€626</td>
<td>Corporation Tax</td>
</tr>
<tr>
<td>Certain company reconstructions and amalgamations</td>
<td>€496</td>
<td>Stamp Duty</td>
</tr>
<tr>
<td>Reduced rate applied to Marked Gas Oil (MGO) used in home hearing, agriculture, marine and rail sectors (Sections 94-109 Finance Act 1999)</td>
<td>€488.3</td>
<td>Excise Duty</td>
</tr>
<tr>
<td>Excise rate on Auto-diesel</td>
<td>€366.1</td>
<td>Excise Duty</td>
</tr>
<tr>
<td>Medical Insurance Relief</td>
<td>€355.7</td>
<td>Personal Tax Credits</td>
</tr>
<tr>
<td>Pension Contribution (Retirement Annuity and PRSA)</td>
<td>€241.3</td>
<td>Pensions</td>
</tr>
<tr>
<td>Health Expenses</td>
<td>€190.1</td>
<td>Personal Tax Credits</td>
</tr>
</tbody>
</table>

| Total for the Top 10                               | €4.78 (Billion) |
| Total for all Tax Expenditures                      | €7.14 (Billion) |

Source: 2021 Tax Expenditures Report. Figures refer to 2020 or latest year available.

Table 1 - Top ten tax expenditures by cost. Source - Budget 2022: Report on Tax Expenditures 2021

RECOMMENDATIONS

1. The Committee recommends that the Department of Finance and Revenue Commissioners agree a definition and publish a common list of tax expenditures.
TAX EXPENDITURE REVIEWS

In 2014 the Department developed and published tax expenditure guidelines\(^4\) to set out a best practice approach to the review of tax expenditures. These guidelines distinguish between two types of evaluations, namely those undertaken prior to the introduction of a new tax expenditure – ex-ante evaluations – and those that relate to existing tax – ex-post evaluations. The guidelines state that tax expenditures should be time-bound, with those of higher costs subject to ex-ante evaluation, and that tax expenditures should also be reviewed on a regular basis.

The Department of Finance stated that scrutiny and analysis of tax expenditures range from their annual consideration as part of Budget preparations and as part of the Tax Strategy Group Papers, to full econometric reviews. The Department also advised that the recommended proportionate approach to the scope and frequency of *ex-post* evaluations of tax expenditures is to be guided by their expenditure costs, split into three levels -

- Level 1 expenditures, which would be ones with an annual cost between €1 million and €10 million, should have a criteria-based review every five years.
- Level 2 expenditures with a cost between €10 million and €50 million should be reviewed every five years, with an interim review after three years if annual costs exceed €25 million.
- Level 3 expenditures costing more than €50 million per annum should be reviewed every three years.

The Department of Finance also noted that stakeholder engagement is a key part of the review process, with public consultations often incorporated to seek the views of taxpayers, representative bodies and other interested persons.

In discussing the reviews of tax expenditures, the Committee is aware that in a report by the previous iteration of the Committee in 2019\(^5\), it was noted that

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approximately 87% of all tax expenditures do not have a sunset clause and approximately 23% of all tax expenditures have never been reviewed. When once again discussing the issue of sunset clauses with the Department of Finance the Committee noted that approximately 75% of tax expenditures do not have sunset clauses and still there are some that have never been reviewed. Responding to this the Department advised that since between 2012 and 2015 almost all measures that have been introduced would have sunset clauses and these should ensure that reviews are triggered.

The Committee also queried how many tax expenditures are worth over €25 million and would therefore be required to be reviewed every 3 years under the Departments own guidelines, but the Department were unable to provide a figure at the time.

Expanding on the matter of reviewing tax expenditures, the Department informed the Committee that there is a resource constraint concerning the number of tax expenditure they can examine annually and advised that this was approximately four or five as they are a small administration.

Considering that only four or five tax expenditures can be reviewed every year and that there are a large number of tax expenditures, the Committee is of the opinion that the Department of Finance is considerably understaffed to undertake the amount of work required to review tax expenditures as outlined under their own review guidelines.

**RECOMMENDATIONS**

2. The Committee recommends that the Department of Finance engage with the Department of Public Expenditure and Reform to recruit the appropriate number of staff and resources necessary to review the number of tax expenditures, as required under Department of Finance guidelines.
RESEARCH & DEVELOPMENT

The R&D Tax Credit provides a 25% tax credit for all qualifying R&D expenditure. This reduces the corporation tax liability of the company for the period the R&D expenditure. Excess credit can be carried back to the previous year and following this, any remaining credit can be carried forward indefinitely for use against future Corporation Tax liabilities, or can be claimed as a repayable credit.

The Department of Finance, in its submission to the Committee, outlined that the primary objective behind the tax credit is to increase business R&D, and more broadly the credit forms part of Ireland’s corporation tax offering aimed at attracting FDI and building an innovation driven domestic enterprise sector.

The R&D Tax Credit is one of the largest tax expenditures, costing around €600 million a year according to the Department of Finance.

The Department of Enterprise, Trade and Employment advised the Committee that a survey undertaken by KPMG found that 74% of respondents stated they would markedly decrease activity in Ireland without the incentive.

TARGETING SMALL AND MEDIUM ENTERPRISE

In discussing the Research and Development Tax Credit, the Committee noted that from the statistics and briefing notes submitted to the Committee, there appears to be an imbalance in the beneficiaries of the R&D Tax Credit. In this regard the Committee notes that the figures for 2020 show that of the 1,616 claimants of the credit, large corporate claimants comprised just 196 or 12% of the total number of claimants, yet claimed €478 million, or 73% of the €658 million claimed (Table 2).
The Revenue Commissioners outlined to the Committee while around 88% of the claims for the credit come from SMEs, 73% of the total value of claims are from large companies that are dealt with by Revenue’s Large Corporates Division (LCD). In 2020, 196 LCD claimants availed on 478 million of the credit, while 1,420 non-LCD claimed €179 million (Table 3).

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Exchequer Cost (€m)</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>70</td>
<td>73</td>
</tr>
<tr>
<td>2005</td>
<td>65</td>
<td>135</td>
</tr>
<tr>
<td>2006</td>
<td>75</td>
<td>141</td>
</tr>
<tr>
<td>2007</td>
<td>166</td>
<td>479</td>
</tr>
<tr>
<td>2008</td>
<td>146</td>
<td>582</td>
</tr>
<tr>
<td>2009</td>
<td>216</td>
<td>900</td>
</tr>
<tr>
<td>2010</td>
<td>224</td>
<td>1,172</td>
</tr>
<tr>
<td>2011</td>
<td>261</td>
<td>1,409</td>
</tr>
<tr>
<td>2012</td>
<td>282</td>
<td>1,543</td>
</tr>
<tr>
<td>2013</td>
<td>421</td>
<td>1,576</td>
</tr>
<tr>
<td>2014</td>
<td>553</td>
<td>1,570</td>
</tr>
<tr>
<td>2015</td>
<td>708</td>
<td>1,535</td>
</tr>
<tr>
<td>2016</td>
<td>670</td>
<td>1,505</td>
</tr>
<tr>
<td>2017</td>
<td>448</td>
<td>1,505</td>
</tr>
<tr>
<td>2018</td>
<td>555</td>
<td>1,503</td>
</tr>
<tr>
<td>2019</td>
<td>626</td>
<td>1,601</td>
</tr>
<tr>
<td>2020</td>
<td>658</td>
<td>1,616</td>
</tr>
</tbody>
</table>

**Table 2 - Overall cost of the R&D credit. Source - Revenue Opening Statement**

Due to the imbalance in the uptake of the R&D Tax Credit that exists between large companies and small to medium sized companies, the Committee queried whether this could be addressed by increasing the R&D credit from 25% to 30% for small companies and noted that there have been previous calls for this measure to be implemented. Responding to this, representatives from the Department of Finance advised that as part of an evaluation of the R&D credit undertaken in 2019, the...
interaction between SMEs and the credit was examined, with elements of R&D regimes in other jurisdictions also looked at.

The Department of Finance advised that the 2019 review led to a number of measures being included in Budget 2020 aimed at providing additional support to micro and small companies including allowing micro and small companies to apply for a further 5% in addition to the 25% provided for under the R&D credit. However, as these were targeted measures they would require State aid approval and so the legislation was introduced in the Finance Act 2019 subject to a commencement order. They advised that following engagement with the European Commission it was determined that it would be necessary to introduce some changes to the measures in order to secure State aid approval but as the measures in their current form are enhancements to the existing general R&D credit, this would present a significant administrative challenge to both applicants and Revenue if different criteria were to apply to two elements of a claim for the same R&D costs. The Department further advised that together with the administrative complications that would arise from implementing the 5% top up as currently proposed, difficulty in advancing the proposal also arose from priorities being diverted to addressing the supports needed by SMEs during the Covid-19 pandemic. In querying the current status of the proposal, the Committee was advised that following the vaccination campaign officials are now examining options to progress the R&D policy to deliver the best outcome for small innovative companies.

In addition to the proposal to increase the R&D credit from 25% to 30%, the Committee also discussed how to increase the uptake and facilitation of the credit for SMEs. In this regard the Committee notes a report commissioned by the Department of Business, Trade and Employment\(^6\) that states –

“The cost of preparing, filing and defending a claim is too high. The criteria for making claims, recording and justifying claims and so on as laid down by Revenue are onerous for SMEs – the rules appear to have been designed

with large established R&D intensive (e.g. pharmaceutical) companies in mind, where development processes are very detailed and structured. In contrast, the rules are not a good fit with, for example, new, agile software development companies, where processes are fluid and fast and documentation is less necessary.” – OECD, 2019

In this regard the Committee noted that this report put forward a number of recommendations including –

- Introducing a pre-approval procedure of R&D tax credits to help reduce uncertainty for SMEs.
- Simplifying the approval procedure for R&D tax credits to facilitate the participation of SMEs in this initiative.
- Maintaining R&D tax credits while trying to increase their take-up by smaller enterprises by design changes and awareness raising

During discussion with the Department of Finance on the topic of removing barriers and facilitating access to the credit for SMEs, the Department advised that they and the Office of the Revenue Commissioners work to build awareness of the credit. When discussing the proposal to implement a simplified approval procedure for the credit the Department advised that they are open to looking at such a proposal and noted that there are no policy objections to introducing a simplified regime.

In their submission to the Committee, the Irish Business and Employers Confederation, IBEC, also noted the disparity in the uptake of the R&D credit between large and small companies and they suggested that a pro-forma R&D tax credit be introduced to help smaller firms engage with the credit. Expanding on this IBEC advised this might include the use of pro-forma templates for R&D project management, recording R&D activity and the calculation of eligible costs and revenue benefits associated with the credit. IBEC also suggested that the R&D tax credit be reviewed to ensure it supports the development of low-carbon technologies, which could be crucial in facilitating firms to invest in innovations that accelerate their transition to lower carbon journeys and help promote Ireland as a location for green R&D.
3. The Committee recommends that the Department of Finance prioritise the development of the R&D tax credit to enable small and medium enterprises to avail of an increased R&D credit of 30%.

4. The Committee recommends that the Department of Finance prioritise the introduction and implementation of a simplified approval procedure for the R&D tax credit for SMEs.

5. The Committee recommends that the Department of Finance prioritise awareness-raising of the R&D credit for SMEs.
KNOWLEDGE DEVELOPMENT BOX

The Knowledge Development Box (KDB) was introduced in the Finance Act 2015, and provides relief from corporation tax on income arising from qualifying assets such as computer programmes and inventions protected by a qualifying patent, or in respect of smaller companies, other intellectual property that is similar to an invention which could be patented.

The Knowledge Development Box provides for a 50% deduction of the profits generated from qualifying assets that have resulted from R&D carried out in Ireland. Qualifying profits are therefore taxed at an effective rate of 6.25%.

The Department of Finance outlined in its submission that the uptake of the KDB has been low, largely due to the complexity of the qualifying criteria and restrictive requirements. Revenue stated that in 2019 (the last year there are full figures as there is a 24-month timeframe for making claims) 20 companies made a claim under the KBD for a total cost of €13.7 million.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Exchequer Cost (€m)</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>6.1</td>
<td>10</td>
</tr>
<tr>
<td>2017</td>
<td>12.2</td>
<td>16</td>
</tr>
<tr>
<td>2018</td>
<td>10.3</td>
<td>15</td>
</tr>
<tr>
<td>2019</td>
<td>13.7</td>
<td>20</td>
</tr>
<tr>
<td>2020 (provisional)</td>
<td>16.3</td>
<td>17</td>
</tr>
</tbody>
</table>

Table 4 - Overall Cost of the KBD. Source: Revenue – Opening Statement

EFFECT OF PROPOSED GLOBAL TAX REFORM

In discussing the Knowledge Development Box, the Department of Finance advised that this credit maybe affected under Pillar 2 of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS). In this regard they note that the KDB at present

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would fall within the scope of the Subject to Tax Rule (STTR), and this is something that will need to be considered this year.

In addition to the above, the Committee notes that the uptake of the KDB credit has been low to date and the Department of Finance has acknowledged that this is due to the restrictive requirements of the relief and the complexity of its qualifying criteria.

With regards the review of the KDB, the Department of Finance advised the Committee that due to limited data and the small number of claimants, little in the way of economic analysis could be undertaken prior to a scheduled review in 2020, and furthermore as a result of the Covid-19 pandemic it was decided to review the credit before the sunset clause of 31 December 2022. The Department informed the Committee that a review has been taking place over the course of 2022 and advised they intended to publish this review on Budget Day.

In its submission to the Committee, IBEC also noted the possible impact of the BEPS process but advised that it may too early in the process to judge the future effectiveness of the scheme. It noted that the implementation of Pillar 2 from January 2024 means it may be of limited use thereafter yet remarked that it may be possible for it to be reworked into a workable incentive for those below the GLoBE (Global Anti-Base Erosion) threshold.

**RECOMMENDATIONS**

6. The Committee recommends that the Department of Finance review the KDB in light of the possible impact of the OECD BEPS initiative.

7. The Committee recommends that the Department of Finance should consider extending the KDB credit to 2024 until there is further clarity on the impact of the OECD BEPS initiative.
APPENDIX 1 : LIST OF WITNESSES

Wednesday 22 June 2022

Department of Finance
- Ms Deirdre Donaghy, head of business tax
- Ms Aisling Greene, assistant principal officer, R&D tax credit and KDB tax credit
- Ms Ian Kavanagh, assistant principal officer, film tax credit
- Mr. Matthew McGann, principal officer
- Mr. Paul Cotter, principal officer

Office of the Revenue Commissioners
- Mr Alan Carey, Principal Officer
- Ms Jacqueline O'Callaghan, Principal Officer,

Department of Enterprise, Trade and Employment
- Dermot Coates, Principal Officer
- Mr. Felix O'Kane, Assistant Principal Officer

APPENDIX 2 : LINK TO MEETING TRANSCRIPT
- Wednesday, 22 Jun 2022

APPENDIX 3 : LINK TO OPENING STATEMENTS
- Deirdre Donaghy, Head of Business Tax, Department of Finance
- Alan Carey, Principal Officer, Business Taxes Policy and Legislation Division, Revenue
- Dermot Coates, Chief Economist, Department of Enterprise, Trade and Employment
APPENDIX 4 : ORDERS OF REFERENCE

219. (1) There shall stand established as soon as may be, following the reassembly of the Dáil subsequent to a General Election, a Standing Committee, to be known as the Committee on Budgetary Oversight, to examine and, where it considers it appropriate, report to the Dáil on—

(a) the overall fiscal position, including—

(i) the aggregated position on revenue and expenditure and the General Government Balance, including structural targets;

(ii) medium-term projections for the public finances;

(iii) macro-economic forecasts and developments;

(iv) general fiscal governance including the application of fiscal rules and risks to the fiscal position; and

(v) matters arising from the introduction of a supplementary Estimate or Estimates that, in its opinion, have or may have significant budgetary implications: Provided that the Committee shall advise the appropriate Committee or Committees of any decision on its part to undertake such consideration and the reason or reasons therefore;

(b) public expenditure policy, including—

(i) the expenditure position having regard to the Government Expenditure Ceiling and the expenditure benchmark under the Stability and Growth Pact;

(ii) Ministerial Expenditure Ceilings applying to individual Estimates or groups of Estimates for the Public Services where significant variations from the expenditure profile could potentially impact on the overall fiscal position; and
(iii) the adequacy of planned and actual aggregate levels of capital expenditure and the policies and practices in relation to capital expenditure, including public procurement policy and public private partnership policy, intended to ensure the achievement of value for money.

(c) Exchequer receipts policy.

(2) The Committee may consider a matter of public policy with significant impact on the budgetary position or on the overall fiscal position: Provided that prior to the commencement of such consideration, the Cathaoirleach of the Committee shall consult with the relevant sectoral Committee established pursuant to Standing Order 95.

(3) The Committee may also consider the overall framework for parliamentary engagement throughout the course of the budgetary cycle and may make recommendations thereon to the Committee on Standing Orders and Dáil Reform for that Committee’s consideration under Standing Order 119(1)(b): Provided that, in so doing, the Committee shall consult with—

(a) the Committees established pursuant to Standing Order 95 on any recommendations which, in the opinion of the Committee, impact on their role or remit; and

(b) the relevant Minister or Ministers on any recommendations which, in the opinion of the Committee, impact on the role or remit of a Department or Departments, and shall notify the results of such consultations to Committee on Standing Orders and Dáil Reform.

(4) The Committee shall have the following powers:

(a) power to send for persons, papers and records as defined in Standing Orders 96(3) and 99;

(b) power to take oral and written evidence and submissions as defined in Standing Order 96(1) and (2);
(c) power to appoint sub-Committees as defined in Standing Order 96(4);

(d) power to engage consultants as defined in Standing Order 96(14);

(e) power to travel as defined in Standing Order 96(15).

(5) Every report which the Committee proposes to make shall, on adoption by the Committee, be laid before the Dáil forthwith, whereupon the Committee shall be empowered to print and publish such report, together with such related documents it thinks fit.

(6) The Committee shall consist of fifteen members, none of whom shall be a member of the Government or a Minister of State, and four of whom shall constitute a quorum: Provided that—

(a) the Committee and any sub-Committees which it may appoint shall be constituted so as to be impartially representative of the Dáil; and

(b) the provisions of Standing Order 106 shall apply to the Committee