

Chapter 5

How individuals reduce their tax bills

Numerous opportunities present themselves for individuals to reduce their tax bills. As with corporations, individuals can choose to manage their affairs in one of three ways:

1. Tax evasion;
2. Tax compliance, and
3. Tax avoidance.

Each term has the same meaning for individuals as it does for corporations. Tax compliance is the process that tax authorities promote and which represents the behaviour of a responsible citizen. Tax evasion is illegal neglect of the responsibilities imposed by tax law. Tax avoidance lies between the two, so whilst likely to be legal it involves abuse of normal understanding of taxation law.

Tax planning

Tax planning happens when a person seeks to manage their tax liabilities. The ways in which an individual might do this can cover a wide range of taxes e.g.:

1. Income taxes;
2. Social security contributions;
3. Value added tax (VAT) or Goods and services taxes (GST);
4. Capital gains taxes;
5. Wealth or inheritance taxes;
6. Duties and other charges e.g. on imports, trading or particular

contracts and products, many of which will be luxuries;

7. Gift taxes;
8. Environmental taxes;
9. Taxes from countries other than their own.

Given this wide range of taxes, and because the actions an individual takes to avoid one tax often have impact on the amount of another tax they pay, this area is especially complex and the variety of mechanisms used are enormous and vary from country to country. The following generalisations are possible, however:

1. **Poor people don't plan their tax bills.** There are three good reasons:

- They don't have tax bills;
- They cannot afford to pay the costs associated with tax planning;
- Tax planning usually requires the person undertaking it to have income in excess of their current needs: by definition this excludes most people from the activity.

2. **The wealthiest in society have greatest opportunity to plan their tax liabilities.** This is because:

- Tax planners charge highly for their services, which means that only the wealthiest can afford their fees. The result is that, inevitably, the

opportunity to ‘minimise’ tax liabilities in this way is restricted to limited groups in society. This almost certainly explains why in the UK, for example, the effective overall tax rate of the top decile of income earners in 2001-02 was 33.6 per cent, which was the lowest rate bar that for the third decile (32.7 per cent) and substantially below that for the bottom decile (53.3 per cent).¹²²

- Tax planning almost always requires the person undertaking it to have cash or other resources which they do not need to use immediately. By definition this means that the person has wealth in excess of current needs, which is not the case for the vast majority of the world’s population;
- The wealthiest members of society are the most mobile. Tax planning sometimes requires this;
- Capital is transient in its location, and easy to relocate. People find it much harder to move. Capital is owned by the wealthiest members of society.

3. The self employed have more opportunities for tax planning than those who are employed. The reasons are:

- In a majority of countries in the world the income of employed people is subject to tax at source i.e. before the tax payer receives payment. This means that the scope for tax planning is considerably reduced and any planning is undertaken with regard to investment income or in the claiming of expenses, of which there tend to be fewer allowed for employed people than the self employed;
- In contrast, self employed people usually pay their tax after calculating the profits arising from their activities

in self employment and this provides many more opportunities for determining what is to be considered income, and what expenses might be allowed. This means they can usually plan taxation liabilities due on the whole of their income, whether resulting from their own efforts or from investment sources. As such, at least some of the opportunities for planning already noted for corporations may also be available to the self employed. Since many such opportunities have an international dimension and most self employed people work only in the country in which they both reside and work, this limits the possibilities for legitimate use of those arrangements.

4. Those with international links often have greatest opportunity to plan their tax affairs. The reasons are:

- If a person is resident in more than one country it provides them with some opportunity to choose under which countries rules they will be taxed;
- If a person has family in more than one country it might provide opportunity to divert income to lower tax territories;
- As soon as more than one country is involved in any tax situation it becomes harder to obtain information to determine whether abuse is taking place, or not;
- Those who have employments in more than one country can split their income to ensure that part at least is subject to lower rates of tax. This is commonplace amongst internationally mobile people such as many business executives;
- The opportunity to flee is the ultimate way to avoid tax, especially as countries rarely cooperate

¹²² Hills, J *Inequality and the State* Oxford, 2004, page 168.

effectively in collecting tax debts due to each other.

Ways to save tax

Against this background, the ways in which individuals can save tax include (but are by no means limited to) the following examples, which are generic and ignore the numerous opportunities each tax system offers for specific tax planning:

1. Failing to declare income.

This action is tax evasion and is, of course, illegal, but the practice is widespread. Recent studies in Sweden, which is one of the countries considered most tax compliant, suggest that on average self-employed people in that country under-declare their income by 30 per cent¹²³. A study in the UK has suggested a higher rate of non-declaration, with the true income for blue collar self-employed people being more than 100 percent greater than reported income, whereas true income for white-collar self-employed people exceeds reported income by 64 percent. This was based on 1992 data¹²⁴. In the USA the 'tax gap' is suggested to be at least US\$300 billion a year¹²⁵, although the split of this between evasion and avoidance is not known. This sum amounts to about 15 per

123 Engström, P and Holmlund, B (2006); *Tax Evasion and Self-Employment in a High-Tax Country: Evidence from Sweden*; Upsalla University Department of Economics Working Paper 2006:12 downloaded from http://www.nek.uu.se/Pdf/wp2006_12.pdf 22-1-07

124 Lyssiotou, P, P Pashardes and T Stengos (2004), *Estimates of the Black Economy Based on Consumer Demand Approaches*, *Economic Journal* 114, 622-640.

125 <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> accessed 22-1-07

cent of anticipated tax revenues in the USA¹²⁶.

Data on this loss in developing countries is not available. It is believed that the proportionate losses are likely to be higher. For example, *The Swazi Observer* reported on 16 January 2007 that the estimated tax gap (i.e. the difference between anticipated and actual tax revenues) in that country was 41 per cent¹²⁷. Much of this was, however, alleged to be because of fraudulent practice by tax officials.

Whatever the cause, it is likely that tax evasion is the biggest single cause of revenue loss to tax authorities, and almost certainly exceeds the impact of tax avoidance by some way. Measures to tackle tax evasion are, therefore a matter of very high priority for any tax regime wishing to improve its efficiency of tax collection.

2. Moving income out of tax.

The practice will usually be akin to tax evasion, but may also on occasion be tax avoidance. The following practices are common:

- **Moving mobile capital offshore.** The result of this practice is that income arising from capital is not declared by the taxpayer to the tax authority to whom they have to report their income. In addition, the offshore territory is chosen to ensure that it has no duty to provide information with regard to income earned to the tax authority in the country in which the taxpayer is based.

126 http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf accessed 22-1-07

127 <http://www.observer.org.sz/main.asp?id=31499&Section=main> accessed 22-1-07

This practice is likely to be illegal for most taxpayers who undertake it. Nonetheless it is the basis of much of the offshore banking industry. Individuals who operate in this way frequently gain access to their money by using of an offshore debit or credit card. That card is used by the taxpayer in the country in which they live but is settled from a bank account located in the offshore territory in which the taxpayer is holding their funds to evade tax. The debit or credit card need not be held in the name of the person actually using it. Barclays Bank plc was subject to an order to disclose details of many of the offshore credit cards that it ran for UK resident people in 2006. This was in part because a sample survey showed that only 19 per cent of Barclay's customers with UK addresses and cards linked to international accounts made tax returns in the UK¹²⁸. The UK's HM Revenue & Customs expected to recover at least £1.5 billion (US\$2.85 billion) as a result of this single enquiry¹²⁹.

- **Disguising the source of income.** The process of moving income offshore may be assisted by moving the income of the individual into either an offshore trust or company. Very often an offshore company is used, but that is in turn owned by an offshore trust. To be even vaguely legal such an arrangement usually requires the person creating the trust to entirely forego any interest in the income arising from it. In practice the offshore finance industry deliberately ignores this requirement and assists

individuals to evade their tax obligations by creating sham arrangements which have the appearance of being trusts. Such arrangements give the appearance that the individual has foregone an interest in the arrangement, though in reality effective control is retained of the assets in question. For example, the British Channel Island of Jersey passed new trust laws in 2006 designed to facilitate the provision of such arrangements by local financial services providers. These are discussed in more depth in an appendix 5 to this report. The use of these arrangements, whilst entirely legal in Jersey (and other territories where they are commonplace) is likely to constitute tax evasion in the country of residence of the taxpayer making use of them.

- **The income due to a person is attributed to someone else.** For example, income of a parent is attributed to a child who might enjoy their own tax free allowance, or the income of one spouse may be attributed to a non-earning spouse so that they might use tax rates and allowances that might otherwise go unused. These arrangements are commonly used for investment income, where they can be hard to challenge on occasion, and as commonly by the self employed where significant anti-avoidance measures are needed to tackle artificial arrangements of this nature.
- **Income subject to one tax is re-categorised as having a different form which is subject to a different tax, or to no tax at all.** For example, income that should be subject to income tax is re-categorised so that it is subject to capital gains taxes, which are usually charged at lower rates. Many offshore financial

128 http://money.scotsman.com/scotsman/article/articledisplay.jsp?article_id=3014506§ion=Tax&prependForce=SM_XML accessed 22-1-07

129 ibid

services companies provide products to facilitate this objective¹³⁰.

Alternatively, income that is derived from labour is re-categorised through the use of privately owned limited companies as investment income by way of payment of dividends to owners instead of the payment of wages to the same people for providing their labour. As a result social security charges are either avoided or evaded¹³¹.

- **The provision of benefits in kind.** This arrangement provides rewards other than cash to employees who are charged to tax at less than the value of the benefit provided as a result. Commonly provided benefits include company cars and insurance of various kinds, as well as pensions. It is highly likely that this practice falls firmly in the area of tax avoidance.
- **Payment by way of share options.** Use of share options to reward management and staff (with a particular emphasis in practice on management) has been commonplace during the period when maximising 'shareholder value' has been emphasised as the objective of management¹³². It is, unfortunately clear that the availability of such schemes in taxation law has not prevented abuse, which has most often happened by backdating share-

130 See, for example, an explanation at <http://www.moneyextra.com/dictionary/rollup-funds-moneyextra-003659.html> accessed 22-1-07

131 For an explanation see, for example, <http://www.hmrc.gov.uk/ir35/> accessed 22-1-07.

132 For a brief explanation of shareholder value see http://en.wikipedia.org/wiki/Shareholder_value#Shareholder_Value_Maximization accessed 22-1-07

options so that their value can be maximised¹³³. It is estimated that 160¹³⁴ major US companies are being investigated for abusing the use of stock options and that one in ten US company executives may have been involved in the practice¹³⁵. Even when used legally these schemes have too often been subject to generous taxation treatment for both the company making payment of them and the recipient, including on occasion the avoidance of social security obligations on what is otherwise quite clearly labour income.

- **Payment through esoteric mediums.** Some quite incredible payment arrangements have been used to avoid tax and social security contributions, particularly on the earnings of highly paid executives. This practice has required massive anti-avoidance taxation provisions¹³⁶.

3. Claiming expenses and allowances for which tax relief is not available.

Even if all income is declared it remains possible that a person may seek to reduce their tax liability by claiming tax deductions to which they are not entitled. Examples might include:

- **Claiming that expenses have been incurred for business purposes when**

133 For an explanation see <http://www.macworld.com/news/2007/01/17/backdating/index.php?lsrc=mwtoprss> accessed 22-1-07

134 <http://news.independent.co.uk/business/news/article2112605.ece> accessed 22-1-07

135 <http://business.timesonline.co.uk/article/0,,13129-2209355,00.html> accessed 22-1-07

136 See, for example, <http://observer.guardian.co.uk/business/story/0,,1984272,00.html> accessed 22-1-07

in reality they were not. This form of tax evasion is rife and forms the basis of more tax enquiries by tax administrators around the world than probably any other issue, even though the absence of reported income probably gives rise to significantly more taxation loss. The normal practice is for private expenditure to be disguised as having been incurred for business purposes.

- **Making claims for allowances that are not due.**

The variety of these abuses depends upon the tax system of the country in which the taxpayer resides. In general, the more tax reliefs that are available and the more complex tax returns are, the more likely is abuse of this sort. The only effective counterbalance to such abuse is the threat of rigorous tax audit by authorities who have a range of penalties, including the threat of adverse publicity. Claims might however include:

- Allowances for children that do not exist;
- Claims to be married when that is not true;
- Claims for gifts to charities that have not taken place;
- Claims for pension contributions that have not been made;
- Deductions for costs such as those incurred for travelling or for education when such costs have not been incurred.

4. The use of artificial arrangements

This practice is common in some jurisdictions, especially if tax is charged in accordance with the strict interpretation of the letter of the law and in accordance with the

contractual construction of financial arrangements. This is common, for example, in countries that use British law as the basis for their taxation arrangements.

The challenge posed by such arrangements is relatively straightforward to explain. A transaction is designed that complies with the form of the legislation i.e. the strict letter of the law is complied with. The spirit of the law is, however, abused. In other words the substance of the transaction does not comply with its form. Such arrangements are, for example, commonplace with regard to gift, inheritance or wealth taxes where it is claimed that a person has gifted an asset to another person but has, in practice, retained the benefit of the asset gifted for their own use. Other mechanisms frequently involve the use of trusts to engineer transactions which are favourable for tax though in reality little or no economic loss is suffered by the person making the claim for a tax deduction.

These schemes tend to be esoteric. They are often ‘packaged’ as though they are products. It was this practice that KPMG was found to be pursuing in the USA by the Senate Investigations committee. In a report to the US Senate in 2005¹³⁷ it was said that:

The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the Federal tax code. While some

137 Report 109-54 to the 109th Congress (2005) ‘The Role Of Professional Firms In The U.S. Tax Shelter Industry’ available at <http://levin.senate.gov/newsroom/supporting/2005/psi.taxshelterreport.GPOversion.041305.pdf> accessed 22-1-07

of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code.

These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients. The Subcommittee investigation focused on generic abusive tax shelters sold to multiple clients as opposed to a custom-tailored tax strategy sold to a single client.

It was also noted that¹³⁸:

numerous respected members of the American business community were heavily involved in the development, marketing, and implementation of generic tax products whose principal objective was to reduce or eliminate a client's U.S. tax liability.

In an earlier report to the US Senate it was noted that just four artificial schemes marketed by international accountants KPMG might have cost the US Treasury at least US\$7.2 billion¹³⁹. It is clear that the cost of such arrangements is high.

138 *ibid*, page 5

139 Report 108-34 to the 108th Congress (2003) 'U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals', page 3 available at http://www.senate.gov/~govt-aff/files/sprt10834tax_shelters.pdf accessed 22-1-07