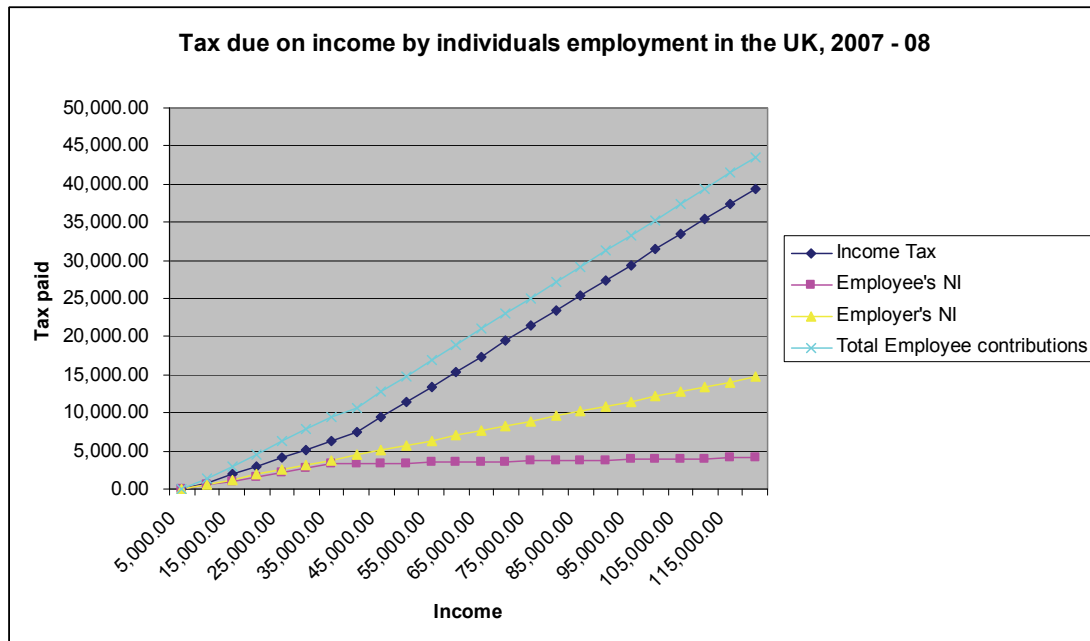


# Technical Appendix 1

## Tax planning by individuals

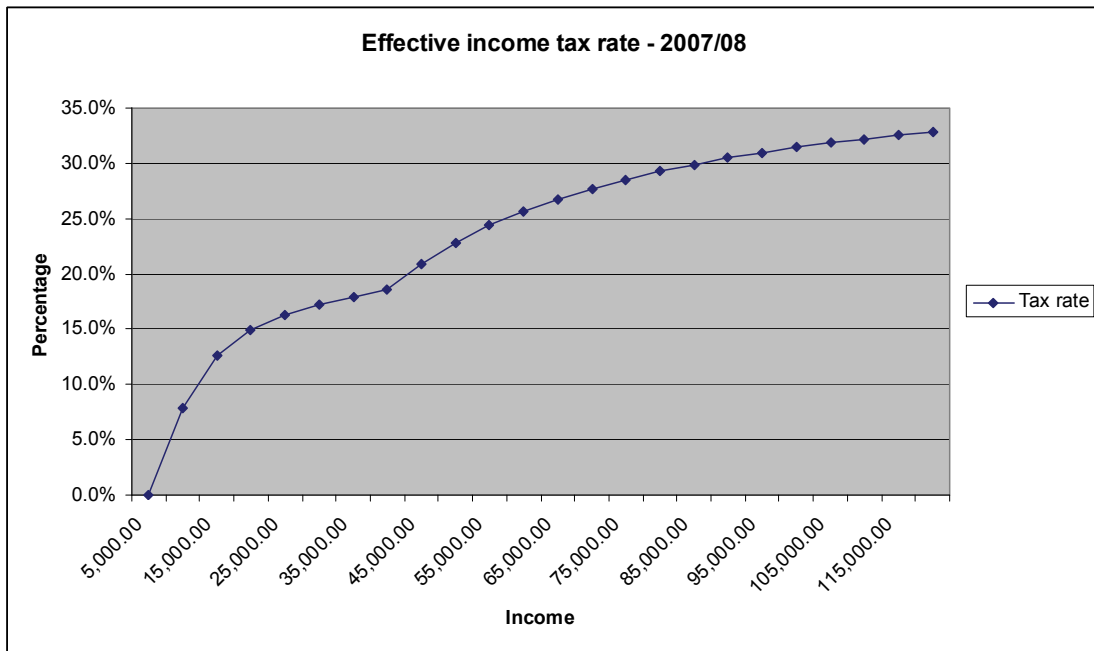
Tax planning is an acceptable activity unless it harms the overall equity of the tax system. This would be the case if an excessive part of the cost of tax reliefs intended to influence behaviour went to those who have little need for the incentives provided and the result was a loss of vertical equity within the tax system as a whole. This needs to be calculated.

The tax that is due, in theory, on employment income in the UK in the tax year 2007/08 is shown by the following graph:

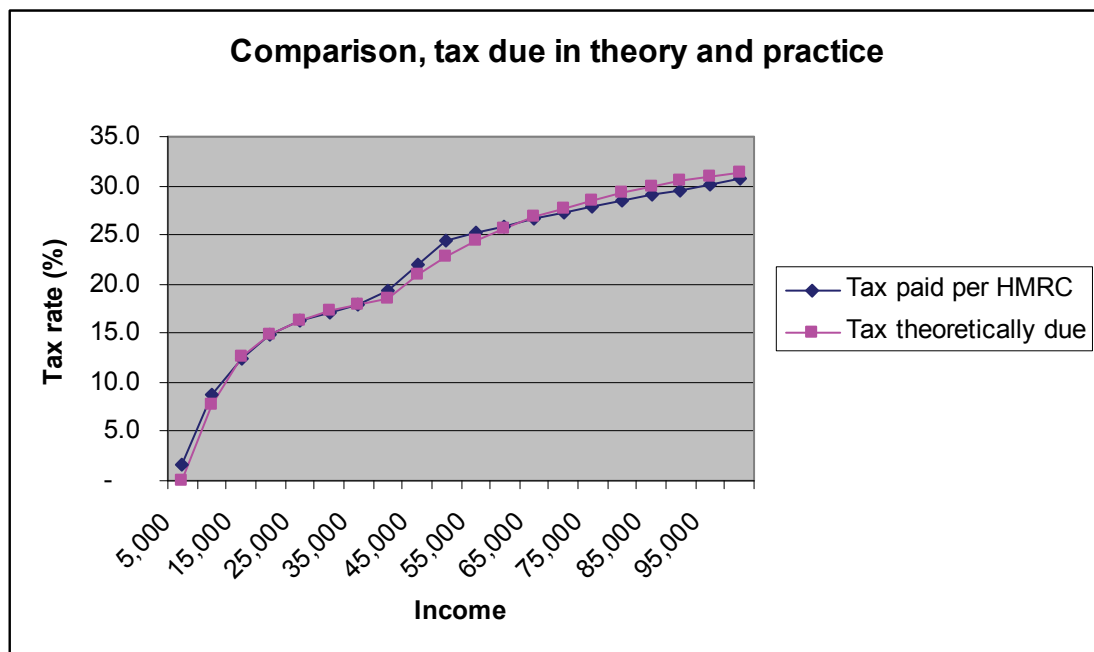


The pattern is clear: income tax appears to be progressive even if employee's national insurance contributions are not. This is what the tax system intends. This is what vertical equity should look like.

The percentage rate of overall income tax due, as reflected in the above graph is shown here:



When this is compared with the data published by HMRC on income tax expected to be paid in 2007-08<sup>1</sup> what is stunning is that there is, apparently almost no divergence:



There is a second, remarkable coincidence. If data from HMRC on average weekly wages by decile<sup>2</sup> is compared with similar information from the Annual Survey of

<sup>1</sup> [http://www.hmrc.gov.uk/stats/income\\_tax/table2-5.xls](http://www.hmrc.gov.uk/stats/income_tax/table2-5.xls) accessed 18-10-07

<sup>2</sup> [http://www.hmrc.gov.uk/stats/income\\_tax/table2-7.xls](http://www.hmrc.gov.uk/stats/income_tax/table2-7.xls) accessed 18-10-07

Hours and Earnings (ASHE) for 2005-06<sup>3</sup> (the last year available) the data is remarkably similar:

	bottom decile	lower quartile	median	upper quartile	top decile
Weekly:	£	£	£	£	£
ASHE	244.1	316.3	447.1	632.9	886.1
HMRC	240.5	312.3	440.9	626.1	869.7
Difference	3.6	4	6.2	6.8	16.4
Annualised:					
ASHE	12,693	16,448	23,249	32,911	46,077
HMRC	12,506	16,240	22,927	32,557	45,224
Difference	187	208	322	354	853

£853 difference a year from each top decile household does not suggest that a substantial amount of tax planning is taking place.

What this coincidence does suggest, however, is two things. The first is that this data reflects incomes after tax has been avoided. The second is that since top decile earnings start at £45,000, which is a good but by no means exceptional salary for an employee in the UK, there are a substantial number of people earning more who might well be avoiding significant amounts of tax. That is not shown by this published data because it lacks sufficient detail on the behaviour of those earning over £50,000 a year.

Three million six hundred and seventy thousand people pay tax at higher rates in the UK<sup>4</sup>. This means they have taxable income in 2007/08 of in excess of £34,600 meaning that their actual earnings when personal allowances are taken into account would need to exceed approximately £40,000. This group represent 11.6% of all taxpayers but they pay 55% of all income tax<sup>5</sup>.

This information still provides no indication of the extent of tax planning undertaken across the income brackets found in the UK. To explore this, data from 2004/05 has to be used. This is because it is the most recent available for this purpose: publication of the information in question appears to have ceased when the Inland Revenue merged with HM Customs & Excise when HM Revenue & Customs was formed. The analysis that follows is all based on data published by HM Revenue & Customs on personal incomes for that year<sup>6</sup> and most particularly uses tables 3.4, 3.5 and 3.8. These produce the following information, the figure used for each tax bracket being the lower value for the range:

<sup>3</sup> <http://www.statistics.gov.uk/pdfdir/ashe1006.pdf> accessed 18-10-07

<sup>4</sup> [http://www.hmrc.gov.uk/stats/income\\_tax/table2-1.xls](http://www.hmrc.gov.uk/stats/income_tax/table2-1.xls) accessed 29-10-07

<sup>5</sup> Derived from [http://www.hmrc.gov.uk/stats/income\\_tax/table2-6.xls](http://www.hmrc.gov.uk/stats/income_tax/table2-6.xls) accessed 29-10-07

<sup>6</sup> [http://www.hmrc.gov.uk/stats/income\\_distribution/menu.htm](http://www.hmrc.gov.uk/stats/income_distribution/menu.htm) accessed 29-10-07

Income Bracket £	Tax paid (Total) £mil	Value of reliefs (pre tax) £mil	Marginal Tax rate	Cost of relief £mil
4,745	84	40	10%	4
6,000	2,575	475	10%	48
10,000	7,869	1,305	22%	287
15,000	11,215	2,060	22%	453
20,000	22,536	4,570	22%	1005
30,000	27,194	5,910	22%	1300
50,000	12,100	2,110	40%	844
70,000	9,480	1,530	40%	612
100,000	12,600	2,030	40%	812
200,000	8,790	1,380	40%	552
500,000	3,910	621	40%	248
1,000,000	4,610	754	40%	302
	122,963	22,785		6,467

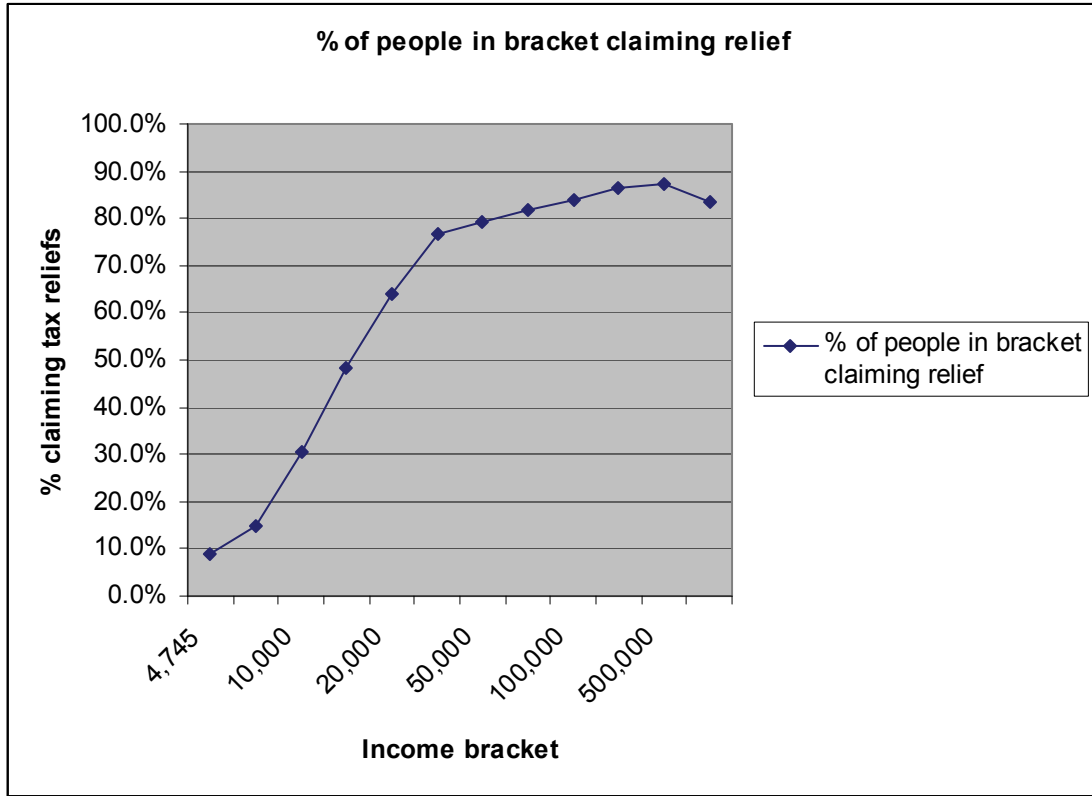
It is stressed that the reliefs in question are of a limited range and a broader range of reliefs are considered below. Even so, this table already shows some key information. For example, those earning over £70,000 in the year in question paid 32% of all income tax but enjoyed the benefit of 39.1% of all tax reliefs.

The data set can be extended to reflect the number of people involved:

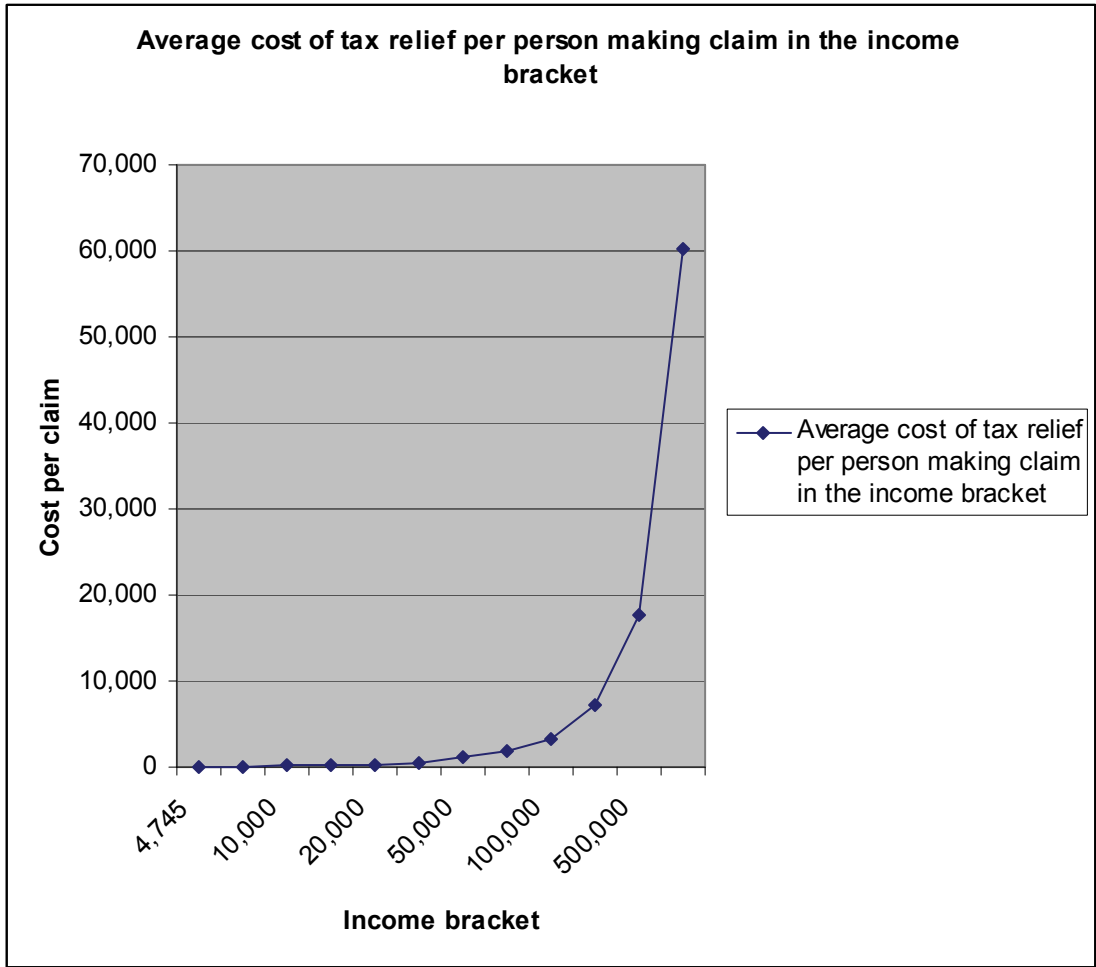
Income Bracket £	People making claim 000	Cost per person £	Number in bracket	% of people claiming
4,745	128	31	1,432	8.9%
6,000	887	54	5,991	14.8%
10,000	1,910	150	6,302	30.3%
15,000	2,360	192	4,869	48.5%
20,000	3,810	264	5,939	64.2%
30,000	3,120	417	4,058	76.9%
50,000	677	1,247	856	79.1%
70,000	335	1,827	409	81.9%
100,000	251	3,235	299	83.9%
200,000	76	7,263	88	86.4%
500,000	14	17,743	16	87.5%
1,000,000	5	60,320	6	83.3%
	13,573		30,265	

Now it is clear that just 2.7% of people are in the brackets starting at £70,000 and above, but between them enjoy 39% of all tax reliefs when expressed in terms of tax saved. Those reliefs are worth more than £60,000 of tax saving, on average, for those earning over £1 million a year.

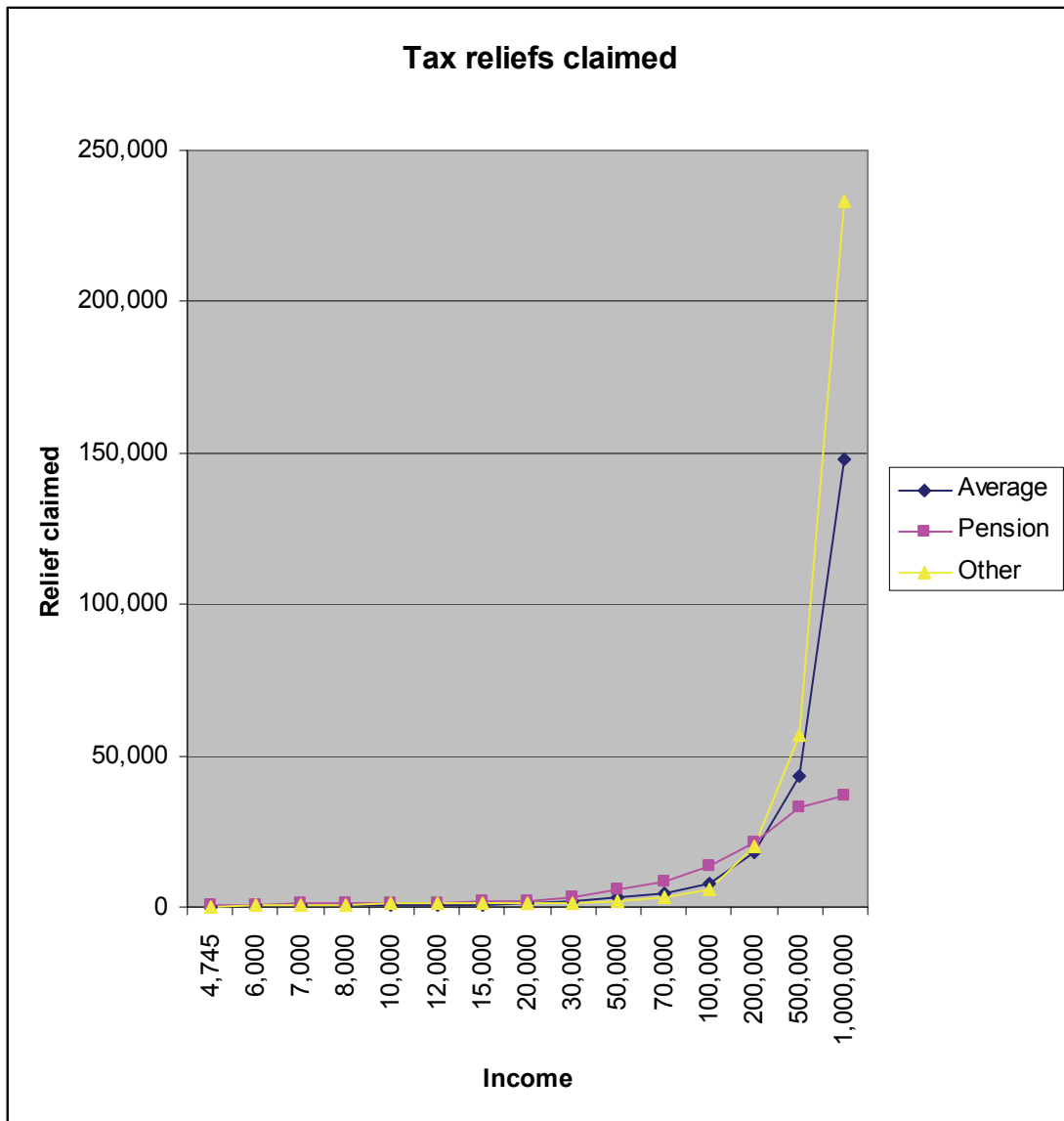
As is also clear, the percentage claiming reliefs rises with income. As the table makes clear, just 8.9% of those earning about £5,000 per annum make a claim for any sort of tax relief, and benefit by just £31 each, on average. The increase in the proportion claiming relief is dramatic:



The increase in the value of their claims made is more dramatic still:

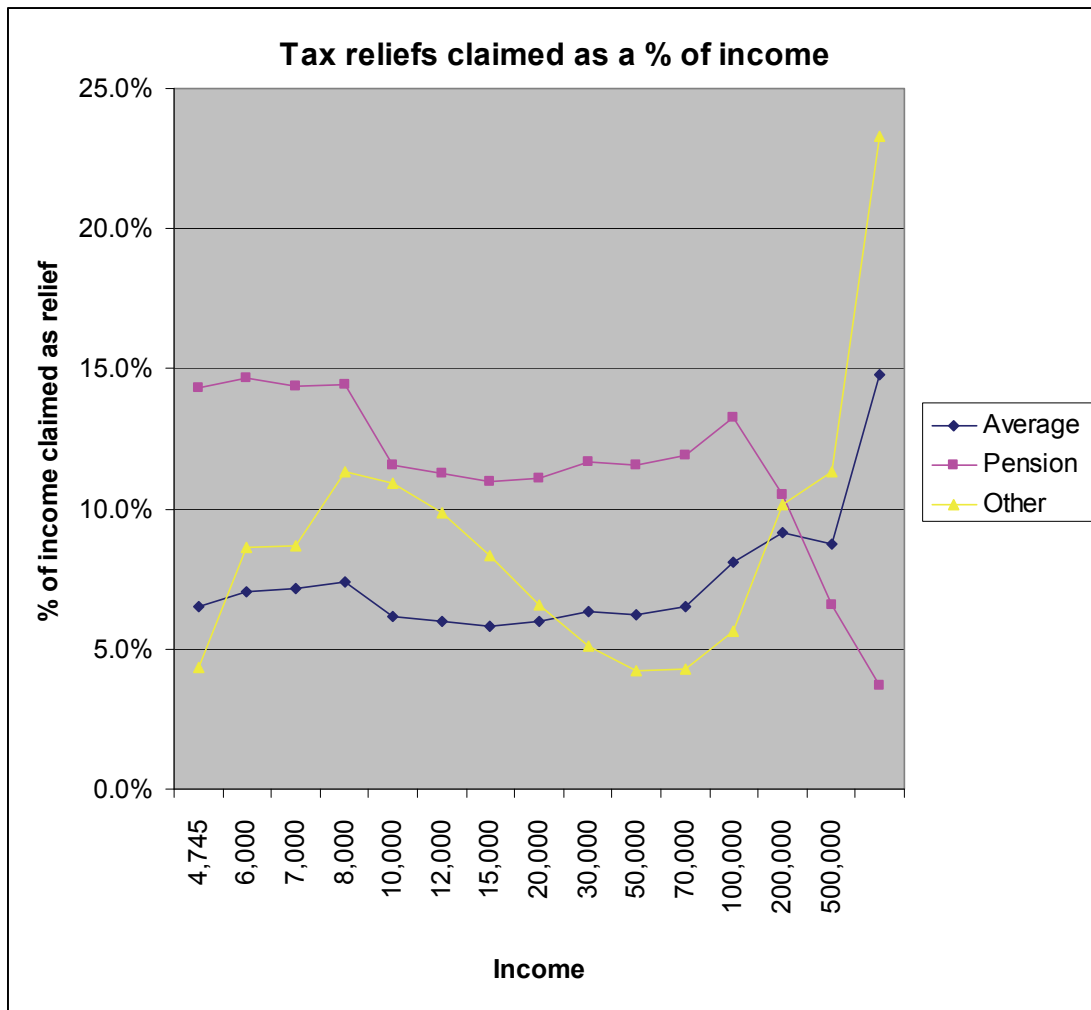


If the claims are expressed according to the value deducted from income, and by type of claim, the same dramatic increase is seen:



What is stunning in this case is that tax relief claimed on pensions ceases to be as significant at the highest levels of income and “other claims” predominate. These are much less significant for all other groups and suggest that many tax reliefs are really only of much significance to this very small group in society.

Perhaps more tellingly, each type of claim expressed as a percentage of taxable income is as follows:



The relative importance of claims for pension relief falls as income rises. In contrast, except for those on very low incomes claiming what are, almost certainly, fixed deductions allowed for certain occupations it is apparent that the value of “other reliefs” is almost insignificant until income exceeds £70,000.

It should be stressed though that these other claims are not for basic allowances, they are described as being for “All other interest, charges and deductions”. The overall value of all identified claims of this sort (i.e. the amount by which income is reduced as a result of the claim made) is as follows for the most recent year available<sup>7</sup> (2006/07):

<sup>7</sup> [http://www.hmrc.gov.uk/stats/tax\\_expenditures/table1-5.xls](http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.xls) for 2006-07

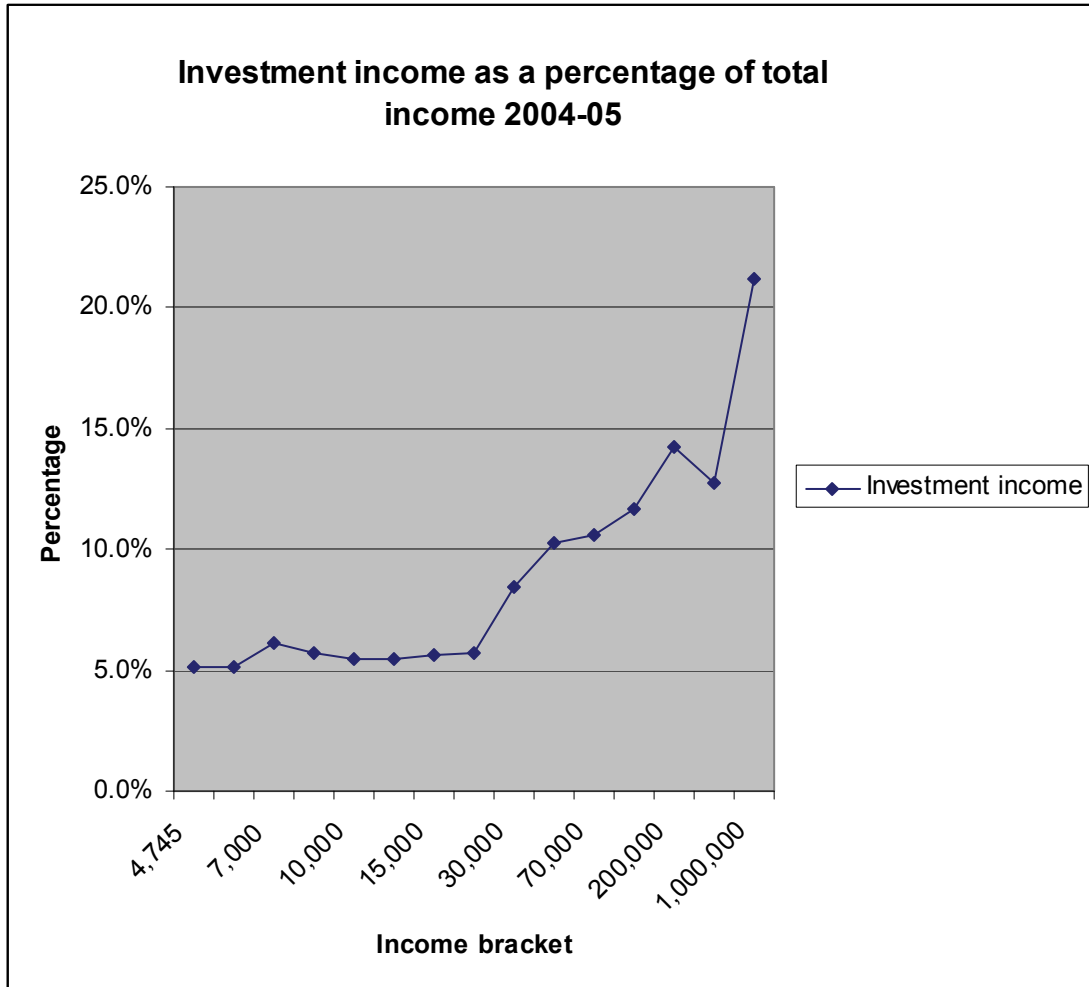


	Estimated cost for 2006-07 £ mil
Relief for:	
Approved pension schemes	16,300
Share Incentive Plan	280
Approved savings-related share schemes	140
Enterprise Management Incentives	120
Approved Company Share Option Plans	190
Personal Equity Plans	475
Individual Savings Accounts	1,625
Venture Capital Trusts	75
Enterprise Investment Scheme	140
Professional subscriptions	80
Rent-a-room	100
Seafarers' Earnings Deduction	100
Exemption of:	
First £30,000 of payments on termination of employment	800
Interest on National Savings Certificates including index-linked certificates	150
Premium Bond prizes	200
Income of charities	1,200
Foreign service allowance paid to Crown servants abroad	95
Life assurance premiums (for contracts made prior to 14 March 1984)	50
Small budget film tax relief	240
Large budget film tax relief	240

The total of such reliefs amounts to £22,600 million, a figure sufficiently similar in amount to that shown for the 2004/05 tax year above to assume that there is substantial overlap in the data.

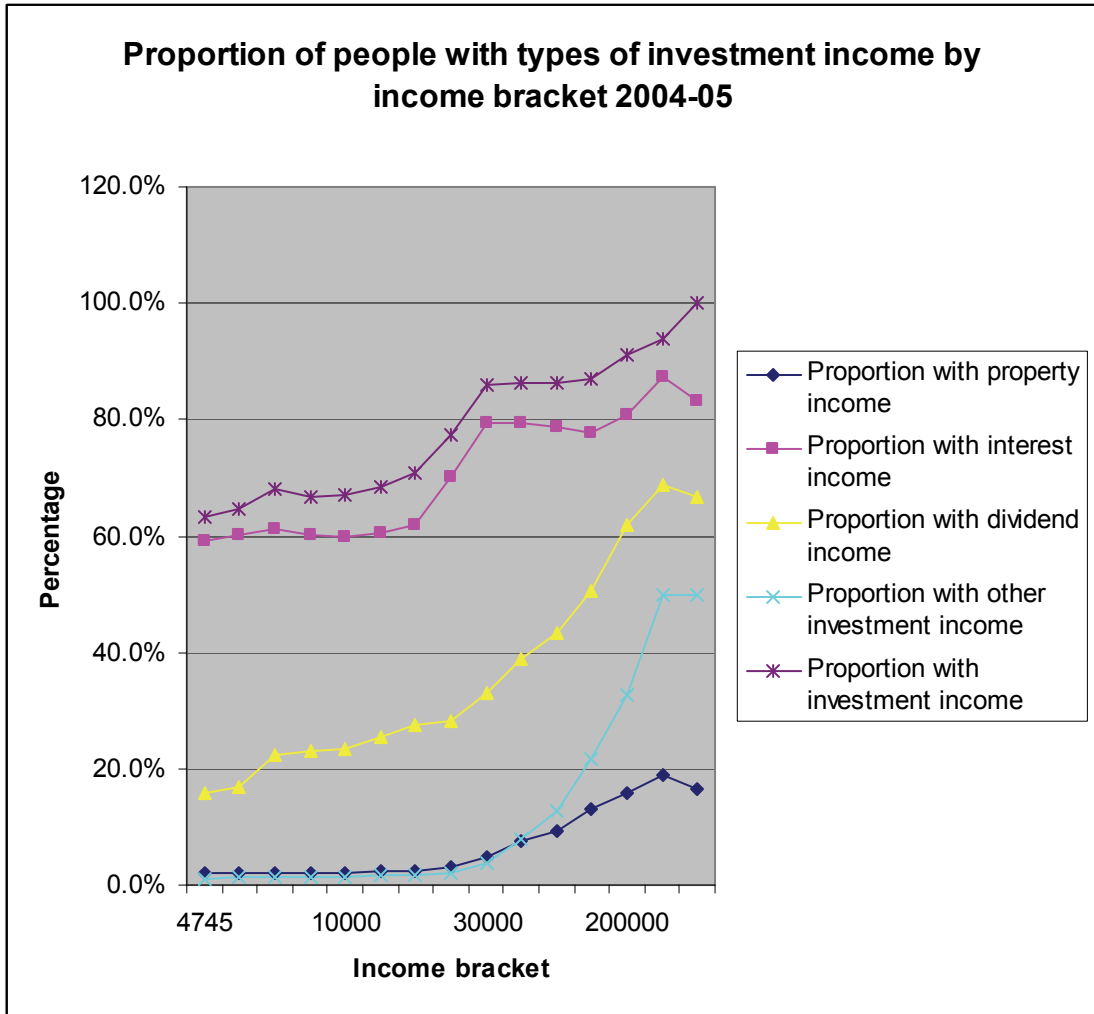
What is apparent is that pension allowances dominate the reliefs given, and that many (but not all) of the rest relate quite strongly to investment income. As this graph shows, investment income is of by far the greatest significance to the wealthiest in society<sup>8</sup>:

<sup>8</sup> Source [http://www.hmrc.gov.uk/stats/income\\_distribution/table3-5.xls](http://www.hmrc.gov.uk/stats/income_distribution/table3-5.xls) accessed 30-10-07



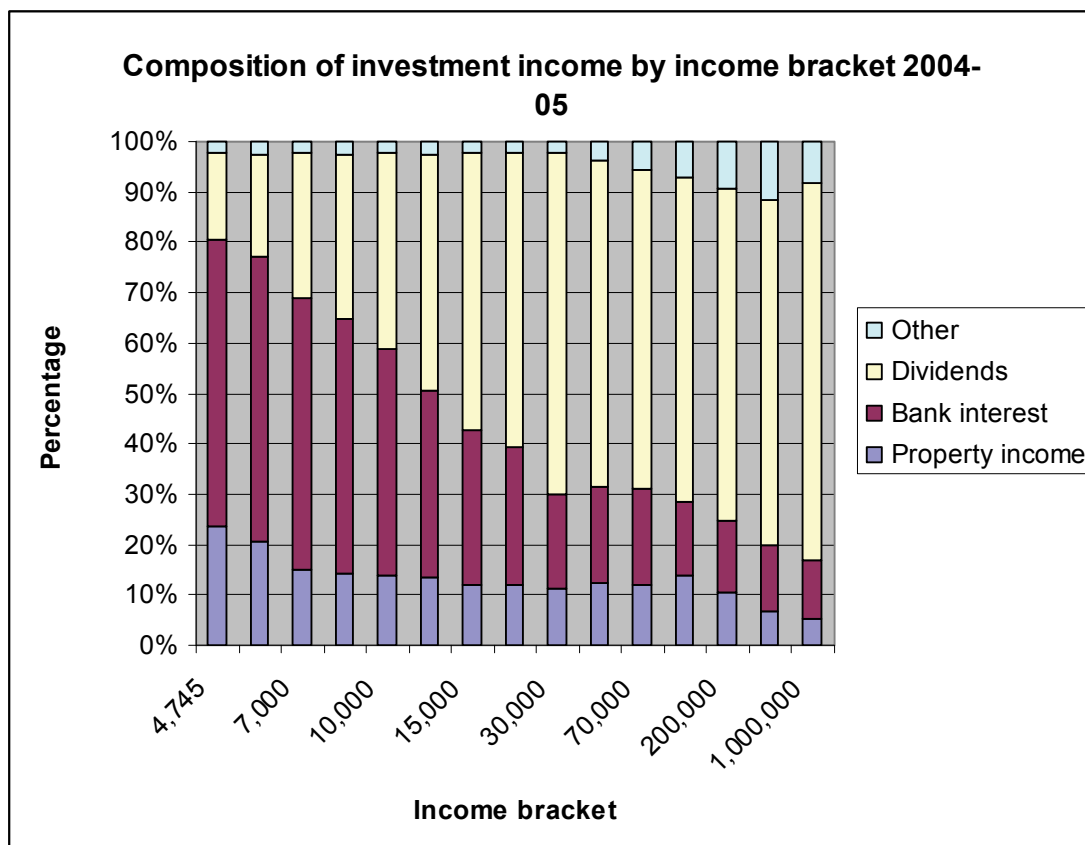
Since it is investment activity that attracts many tax reliefs these must, inevitably, be given to the wealthiest in society.

The significance of this trend is, however, understated if only income tax reliefs are considered. Earned income is for the vast majority of people in the UK subject to national insurance charges on top of income taxation. For those earning between £5,000 and £35,000 in the UK in 2007/08 national insurance effectively increases the basic rate of tax from 22% to 33%. Investment income does not suffer this 50% increase in tax rate and is therefore massively favoured by the tax system. This benefit is unfairly distributed. Many more of the wealthiest, unsurprisingly, on average enjoy having investment income:



Perhaps it is no surprise that 100% of the wealthiest in society have investment income but this ratio is not achieved by any other group.

The composition of investment income also changes dramatically with income:



The starkest change is the massive increase in the importance of dividend income as wealth rises. This has another consequence entirely unseen within this data though: many of the most well off in society own their own companies and as such can decide how they will pay themselves. As noted above, dividends do not attract national insurance charges but earned income paid as a salary does. Therefore many people try to set up their own companies to avoid national insurance charges. In April 2007 alone some 35,000 new companies were registered in the UK, at least in part for this reason<sup>9</sup>.

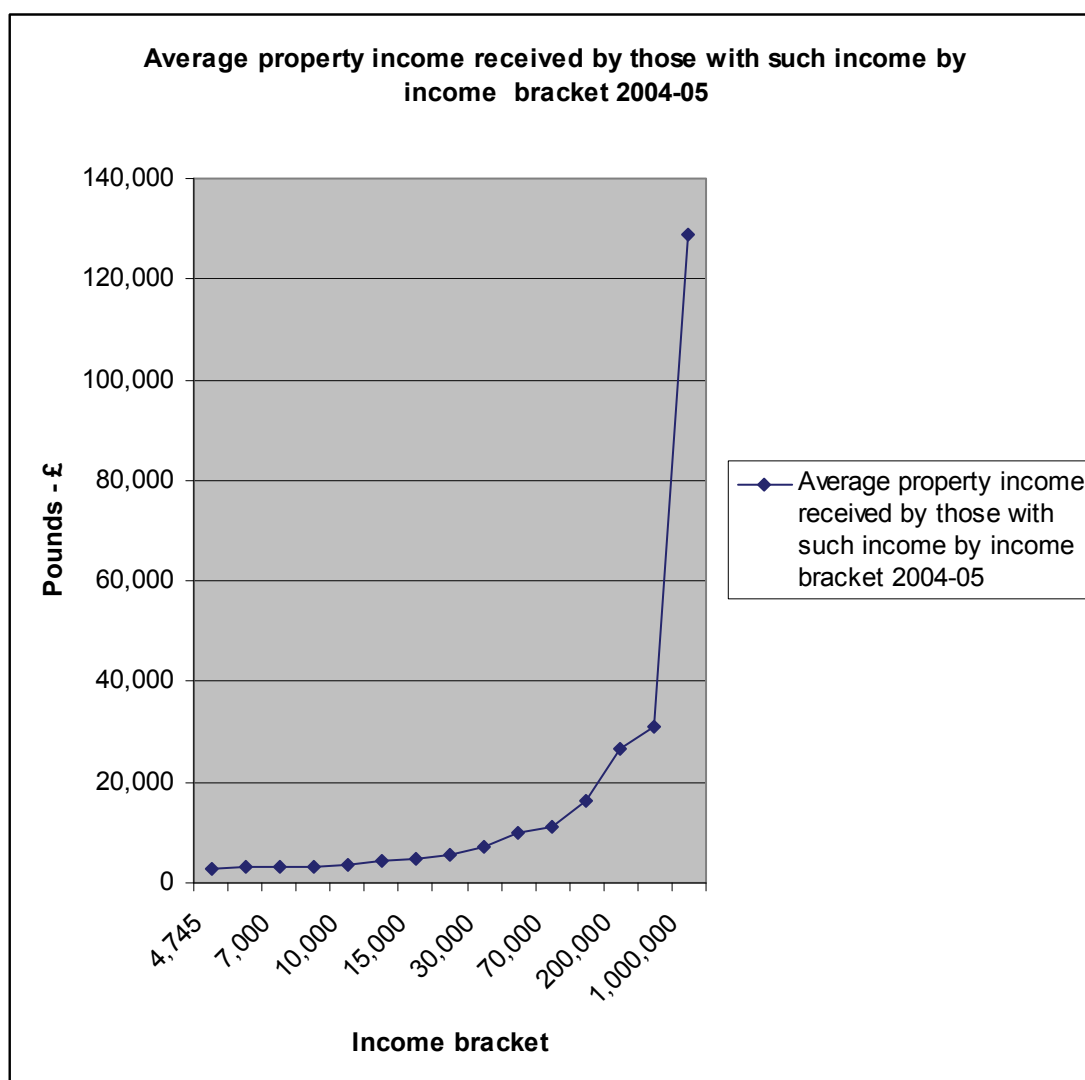
Such arrangements have also been used to divert income from a ‘working partner’ to a non working partner who suffers a lower rate of tax by way of paying them a dividend on the nominal value of shares they hold in the company. One estimate has suggested that the tax lost as a result of this arrangement might be as much as £1.2 billion a year<sup>10</sup>. The 2007 Pre-Budget report suggests it is much lower at about £260 million a year<sup>11</sup> but considered only a part of the issue. Either way, it is clear that income shifting of this sort is very costly and is not reflected in any official data.

<sup>9</sup> <http://www.companieshouse.gov.uk/about/busRegArchive/statsAprilWorkload07.pdf> accessed 30-10-07

<sup>10</sup> <http://www.taxresearch.org.uk/Documents/TRLLPSmallBusinessTax8-08.pdf> accessed 30-10-07

<sup>11</sup> [http://www.hm-treasury.gov.uk/media/F/9/pbr\\_csr07\\_annexb\\_305.pdf](http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf) accessed 30-10-07

Surprisingly the graph shows that property income is of greatest proportionate value to the very lowest earning in society. However, it must be stressed that those receiving such income received the following sums, on average, each in 2004/05:



The significance of property income might appear highest to those on low incomes but until incomes exceed £50,000 the amounts earned by those in receipt of such income are relatively modest. The proportion receiving them is more modest still, as also shown above. 2.2% of the poorest in society have property income. 18.8% in the income bracket starting at £500,000 do so.

There is a further explanation for the apparent disparity in the relative proportion of property income in the wealthiest and poorest's income portfolios. Almost certainly those with high levels of property income will have borrowed to buy such property, so reducing the apparent value of their income return since the income they receive from property will be reduced by the amount of tax relief that they enjoy on the interest that they pay on their borrowings. Those on lower incomes are unlikely to have such borrowings for three reasons. Firstly they are almost certainly more risk averse. Secondly, they may well not be able to secure the

borrowings from banks and other such lenders. Third their income may arise from letting rooms rather than a whole property. The average income at this level is within the limit for the Rent-a-Room scheme. If this reasonable analysis is correct then the amount of tax relief provided to the well off may be considerably in excess of the ratios already noted.

If, as seems reasonable the proportion of gross income from property might be as significant for the well off in society as it is for the least well off, then the difference in the taxable figures must be due to the offset of expenses, most of which will be interest. If the gross income was restated so that a constant proportion of gross (pre-expenses) investment income were attributed to property then that sum by income bracket would increase as follows:

Income bracket	Declared property income	Required property income to be 23.7% of portfolio	Additional income
4745	93	93	0
6000	80	95	15
7000	109	192	83
8000	213	405	192
10000	229	442	213
12000	355	720	365
15000	580	1,315	735
20000	1,010	2,260	1,250
30000	1,420	3,500	2,080
50000	629	1,365	736
70000	427	960	533
100000	631	1,225	594
200000	377	995	618
500000	95	402	307
1000000	146	795	2,030
Total	6,394	14,764	9,751

This can of course be, at best, a crude approximation to the amount of interest paid on buy-to-let properties. However, its relevance might be gauged from the reported fact that 330,000 buy-to-let loans, worth a total of £38.4 billion, were agreed during 2006<sup>12</sup>. Given that the average life of a mortgage before refinancing is now around four years on average<sup>13</sup>, this suggests a loan balance for buy to let mortgages of up to £150 billion. In practice it is likely to be a little less because loan life in this market might be shorter as it is highly commercial and because average loans taken have increased with property prices. Even so, a balance of buy-to-let mortgages somewhat in excess of £100 billion is likely, on which interest

<sup>12</sup> [http://www.iii.co.uk/articles/articledisplay.jsp?article\\_id=7183071&section=Tax](http://www.iii.co.uk/articles/articledisplay.jsp?article_id=7183071&section=Tax) accessed 30-10-07

<sup>13</sup> [http://www.perspecta.com/whitepaper/consequences\\_of\\_remortgaging.pdf](http://www.perspecta.com/whitepaper/consequences_of_remortgaging.pdf) accessed 30-10-07

of more than £7 billion per annum is likely. In that case the table noted above may mildly overstate the situation on gross as opposed to net incomes arising from property letting, but not by much. Either way, the total value of reliefs granted to those making claim has to increase from approximately £22 billion as noted by HM Revenue & Customs to almost £30 billion.

It is therefore important to estimate who gets most benefit from these reliefs. In doing so it is recognised that information on reliefs claimed is only available until 2004/05 and data on reliefs given is for the later year of 2006/07, but the resulting distortion is highly unlikely to be significant. If, using the data noted, the value of reliefs given is calculated dependent upon the amount claimed weighted by the tax rate likely to be attributable to it then the following percentage allocation of reliefs by value results:

Income bracket	% of pension relief attributed	% of other reliefs attributed	% of rental reliefs attributed
4,745	0.1%	0.0%	0.0%
6,000	0.1%	0.0%	0.1%
7,000	0.4%	0.2%	0.7%
8,000	1.1%	0.6%	1.7%
10,000	1.6%	0.8%	1.9%
12,000	3.4%	1.2%	3.3%
15,000	8.1%	2.3%	6.6%
20,000	18.2%	4.3%	11.2%
30,000	23.4%	6.2%	18.6%
50,000	14.3%	7.5%	12.0%
70,000	10.0%	7.1%	8.7%
100,000	11.8%	14.9%	9.7%
200,000	5.5%	20.6%	10.1%
500,000	1.5%	13.2%	5.0%
1,000,000	0.5%	21.1%	10.6%
	<hr/>	<hr/>	<hr/>
	100.0%	100.0%	100.0%

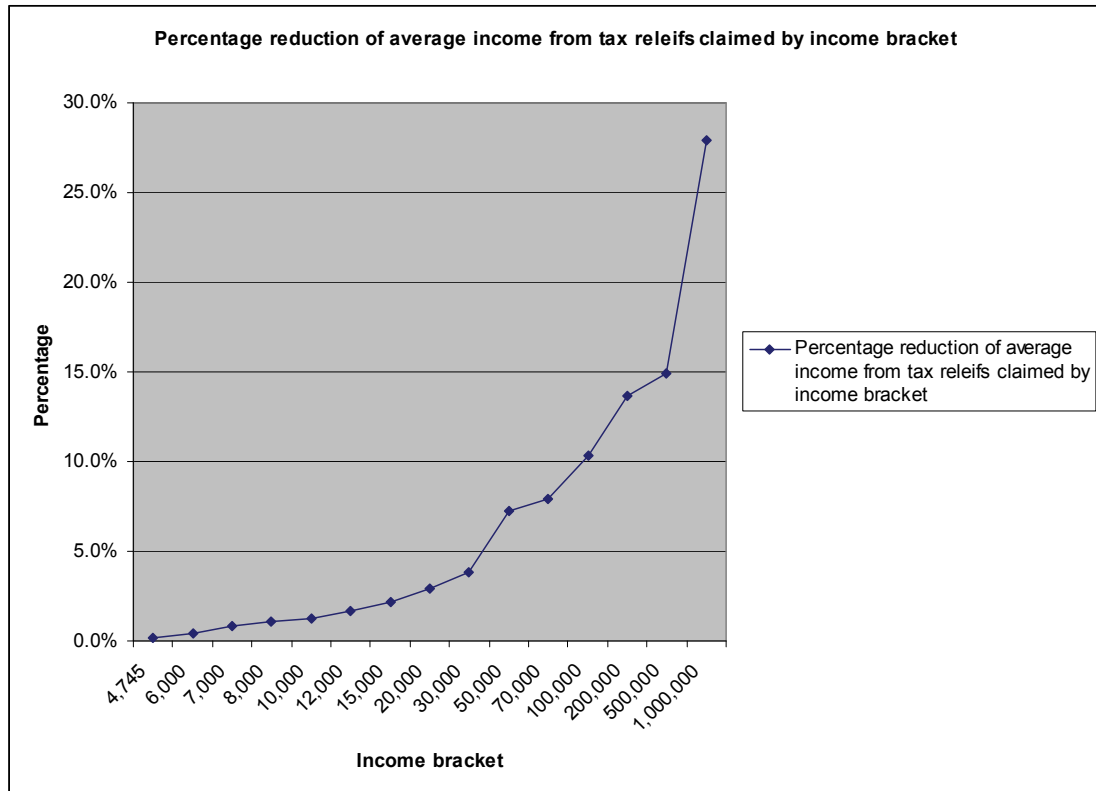
If these proportions are used to allocate the government's own published data on the cost of reliefs given and assuming that all tax reliefs other than pensions relief are weighted in accordance with the "other" category noted above, excepting rental interest relief which is allocated as noted in the calculations shown above, then the value of reliefs provided divided by the number of people in the band to calculate the average value of the relief to each person in a tax band suggests that these values are as follows by category of relief:

Income bracket £	Pension per head £	Other per head £	Rental interest per head £	Total value per person in band £
4,745	8	1	0	9
6,000	20	2	1	23
7,000	41	6	11	59
8,000	60	13	14	87
10,000	93	18	17	128
12,000	153	21	22	196
15,000	268	29	33	330
20,000	495	45	46	586
30,000	931	96	112	1,139
50,000	2,713	551	343	3,607
70,000	3,964	1,085	520	5,569
100,000	6,430	3,139	792	10,361
200,000	10,016	14,556	2,778	27,349
500,000	14,925	51,963	7,675	74,563
1,000,000	13,961	221,711	43,267	278,938

Quite clearly the data is heavily distorted by the extraordinary proportion of "other reliefs" that the well off claim but since these do include many incentives for saving and the cost of exempting the income of charities from tax (which is effectively created by giving tax relief to the donors, and those who claim tax relief on their gifts are almost invariably higher rate tax payers since they actually enjoy a personal tax rebate as a result of gifting to charity which basic rate tax payers do not) this pattern of claim is highly likely to be correct.

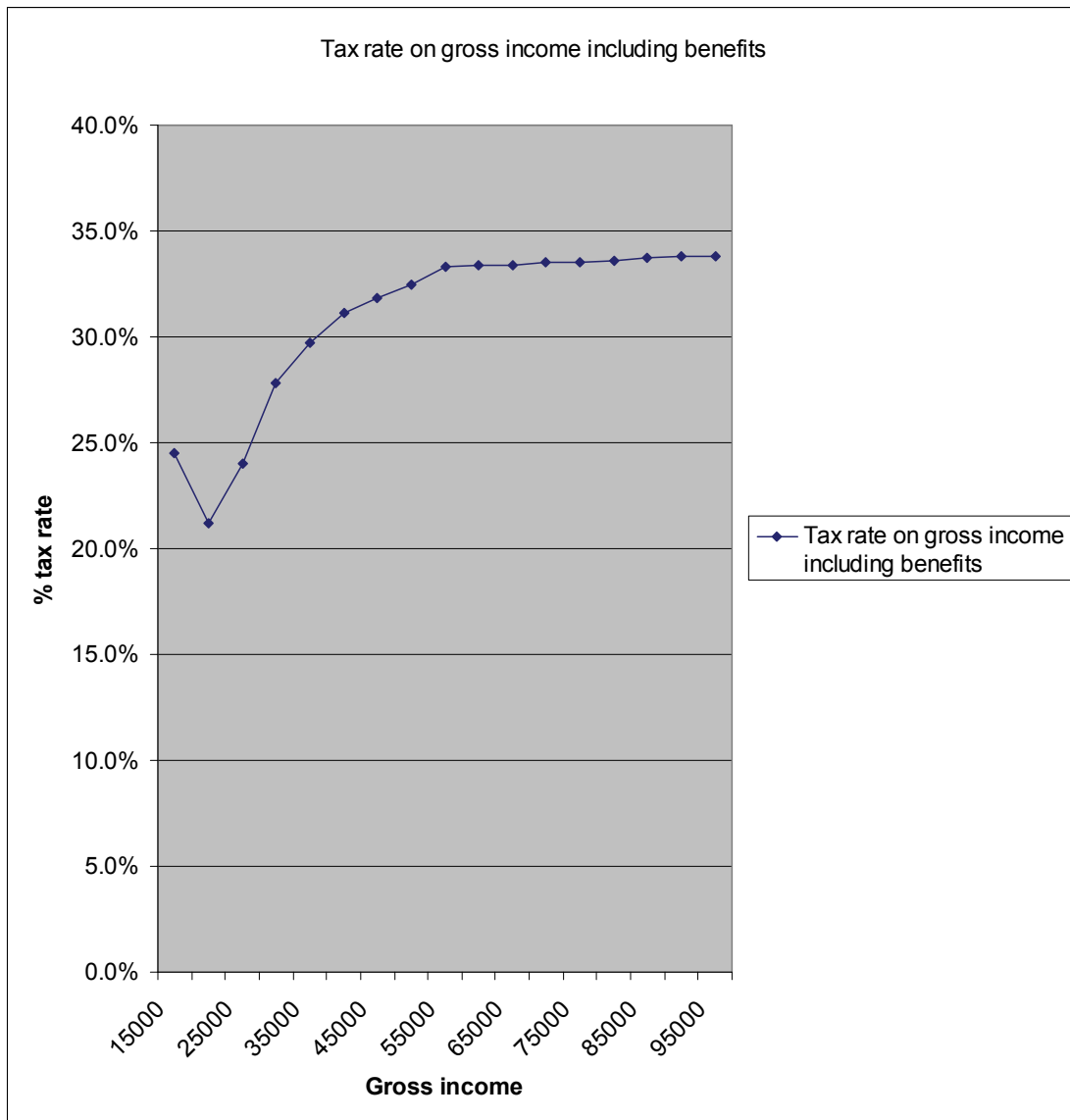


As a percentage of the base level of income in each band this data is as follows:



The point is now very clear. Those who are wealthiest in society do most tax planning, by far. And they benefit most, by far. Which explains why, despite the UK having what appears to be a progressive tax system the effective tax rates of households enjoying income of over £50,000 appears to be almost constant, as this graph based on UK household data information shows<sup>14</sup>:

<sup>14</sup> <http://www.statistics.gov.uk/STATBASE/DatasetType.asp?vlnk=9619> restated to show even income bands



The effect of tax reliefs flattens the apparent impact of higher tax rates over £55,000. It is quite possible that if the household income survey had been broad based enough to collect data on those earning much higher rates the trends noted above would suggest that the effective rates of tax of the very best off in society would fall as incomes exceeded £100,000.

In absolute value the reliefs likely to be granted to the best off in society to achieve this result (those earning over £100,000 being considered in this category) amount to about £8.4 billion on the basis of the calculation used here taking all factors both recognised in published data and calculated here based on that data into account. Given that 79% of all other reliefs given to those earning less relate to pensions which is not considered abusive practice, and that the cost of pension reliefs is restricted to the best off because the amount they can contribute is limited by law then it follows that this figure might be considered the cost of individual tax planning each year in the UK.

The relevance of this sum has therefore to be reiterated. It is because these reliefs are given that the UK tax system lacks vertical equity at its higher end. If that equity is important to the credibility and universal acceptability of the tax system, and it is clear from the design of the tax system that this assumption is implicit within it, then the allocation of this level of relief to those earning over £100,000 undermines that credibility. Tax planning is acceptable, but only when it is of insufficient amount to avoid damage to the system as a whole. The evidence shows that it is damaging the integrity of the UK tax system and as such it is a problem needing to be addressed in its own right for this group of tax payers alone.