

Technical Appendix 2

Income shifting

The relative importance of earned and investment income by income bracket is as follows in the UK¹⁵, each proportion relating to the part of total income of that type that is earned by people in the bracket in question:

Income bracket	% of earned income	Cumulative % of earned income	% of investment income	Cumulative % of investment income
£ 4,745	1.1%	1.1%	0.7%	0.7%
6,000	1.1%	2.3%	0.7%	1.4%
7,000	1.8%	4.0%	1.3%	2.8%
8,000	3.9%	8.0%	2.8%	5.6%
10,000	4.5%	12.5%	3.0%	8.6%
12,000	7.3%	19.8%	4.9%	13.5%
15,000	12.8%	32.5%	8.9%	22.4%
20,000	21.7%	54.2%	15.3%	37.7%
30,000	21.9%	76.1%	23.5%	61.2%
50,000	7.0%	83.1%	9.4%	70.6%
70,000	4.7%	87.9%	6.6%	77.2%
100,000	5.6%	93.4%	8.6%	85.7%
200,000	3.5%	96.9%	6.7%	92.4%
500,000	1.5%	98.4%	2.6%	95.0%
1,000,000	1.6%	100.0%	5.0%	100.0%
	<u>100.0%</u>		<u>100.0%</u>	

Expressed in terms of deciles¹⁶ (with sufficient accuracy for the analysis that follows) this is as follows:

Decile bands	Percentage of total investment income	Cumulative proportion Of investment income
£ 8300	2.8%	2.8%
13100	10.7%	13.5%
16000	8.9%	22.4%
19100	15.3%	37.7%
23400	11.7%	49.5%
29500	11.7%	61.2%
35000	2.3%	63.5%
42300	4.7%	68.2%

¹⁵ Source: http://www.hmrc.gov.uk/stats/income_distribution/table3-5.xls for 2004-05, which is the most recent available

¹⁶ Decile data from <http://www.statistics.gov.uk/STATBASE/DatasetType.asp?vlnk=9619>

52500	2.3%	70.6%
88300	29.4%	100.0%
	<hr/>	
	100.0%	

Astonishingly this data, based on tax return information, suggests that half of all investment income is earned by those in the lower half of the income distribution. Each would have, on average, investment income of about £1,400. The top half of the income distribution would earn a little over £8,600 each on average. Some though, would earn considerably more. The wealth allocation to the two groups would, though, in total be remarkably alike.

However, this tax return based data makes no sense. As data on marketable wealth distribution (i.e. total wealth less the value of domestic properties) shows, wealth in the UK is not distributed in the way the income tax return data implies. The latest data available from HM Revenue & Customs¹⁷ shows that the top 1% of wealth holders have 21% of all marketable assets, the top 10% have 53% of marketable assets and the top 50% have 93%. The bottom half of the profile therefore have 7% between them. Admittedly, the deciles in each distribution need not coincide for statistical reasons, but the reality is that the disparity is so marked that there must be an explanation for the wealth distribution and income distributions being so markedly out of line.

According to the best reported estimate of UK wealth, prepared by the Halifax Bank in 2006¹⁸, cash savings doubled in the decade from 1996, and together with other assets such as shares and pensions were worth £3.634 trillion in 2006. That is £3,634 million million. Fifty five per cent of this sum was held in pension and life assurance products, leaving income generating assets likely to be taxed as investment income on tax returns, having a worth of approximately £1.6 trillion. At an estimated rate of return of a modest 5% this would suggest that at least £80 billion of investment income in total should be declared in the UK. This, however is not the case as a consequence of the split of that sum into different asset types.

Cash represented £960 billion of this sum. In the 2004/05 tax year the Halifax suggests that this sum might, on average, have been about £130 million lower at £830 million on which HM Revenue & Customs suggest £12,600 million of income was declared¹⁹ at an apparent average rate of return of 1.5%. It is obvious as a result that income yields on cash are low. Much must be held on current accounts paying little return.

In contrast, some £32.6 billion of dividend income was declared on all the other assets apparently worth about £550 billion. This implies a rate of return of approximately 5.9%. Given the relative importance of share portfolios to the

¹⁷ Source: http://www.hmrc.gov.uk/stats/personal_wealth/table13_5.pdf accessed 1-11-07

¹⁸ <http://news.bbc.co.uk/1/hi/business/7018253.stm> and <http://www.hbosplc.com/media/includes/29.09.07%20UK%20Household%20Sector%20Wealth%20Position.doc> accessed 1-11-07

¹⁹ http://www.hmrc.gov.uk/stats/income_distribution/table3-7.xls accessed 1-11-07

wealthy, as noted above, this suggests that the distribution of declared income distributions is even more out of line with underlying wealth. Tax free accounts, such as ISAs, with a total value in 2007 of £33 billion²⁰, do not materially distort this analysis.

Applying these rates of return to declared incomes in 2004/05 the results are:

Income bracket	Bank interest	Dividends	Rate of return - cash	Rate of return - shares	Implicit asset value - cash	Implicit asset value - shares	Total asset value	Proportionate holding	Cumulative holding
£	£'mil	£'mil			£'mil	£'mil	£'mil		
4745	223	67	1.50%	5.90%	14,867	1,136	16,002	1.1%	1.1%
6000	218	78	1.50%	5.90%	14,533	1,322	15,855	1.1%	2.3%
7000	393	209	1.50%	5.90%	26,200	3,542	29,742	2.1%	4.4%
8000	767	493	1.50%	5.90%	51,133	8,356	59,489	4.2%	8.6%
10000	747	639	1.50%	5.90%	49,800	10,831	60,631	4.3%	13.0%
12000	993	1250	1.50%	5.90%	66,200	21,186	87,386	6.2%	19.2%
15000	1480	2640	1.50%	5.90%	98,667	44,746	143,412	10.2%	29.4%
20000	2240	4850	1.50%	5.90%	149,333	82,203	231,537	16.5%	45.9%
30000	2400	8590	1.50%	5.90%	160,000	145,593	305,593	21.8%	67.7%
50000	955	3240	1.50%	5.90%	63,667	54,915	118,582	8.5%	76.1%
70000	668	2230	1.50%	5.90%	44,533	37,797	82,330	5.9%	82.0%
100000	673	2940	1.50%	5.90%	44,867	49,831	94,697	6.7%	88.8%
200000	511	2360	1.50%	5.90%	34,067	40,000	74,067	5.3%	94.0%
500000	182	953	1.50%	5.90%	12,133	16,153	28,286	2.0%	96.1%
1000000	314	2030	1.50%	5.90%	20,933	34,407	55,340	3.9%	100.0%
	12,764	32,569			850,933	552,017	1,402,950		

Again, according to this analysis almost half of the wealth owned in the UK is attributable to those whose pay is at or below national average earnings.

This is however inconsistent with the most recent data on wealth distribution²¹, data which has not, regrettably been updated since 2003 although available on a yearly basis prior to that date. Extending the above table and then comparing this with the data from the 2003 wealth analysis, the following can be estimated:

Income bracket	Number in bracket	Proportion in bracket	Cumulative proportion	Wealth each	Likely wealth distribution per HMRC data
£	'000			£	
4745	1,440	4.8%	4.8%	11,113	2000
6000	1,160	3.8%	8.6%	13,668	3000
7000	1,590	5.3%	13.8%	18,706	4000
8000	2,950	9.7%	23.6%	20,166	5000
10000	2,760	9.1%	32.7%	21,968	15000
12000	3,650	12.1%	44.8%	23,941	36000
15000	4,950	16.4%	61.1%	28,972	56000

²⁰ <http://www.hmrc.gov.uk/stats/isa/table9-4-2006-07.pdf> accessed 1-11-07

²¹ http://www.hmrc.gov.uk/stats/personal_wealth/table13_5.pdf accessed 1-11-07

20000	6,000	19.8%	80.9%	38,589	76000
30000	4,090	13.5%	94.4%	74,717	270000
50000	859	2.8%	97.3%	138,046	460000
70000	410	1.4%	98.6%	200,805	600000
100000	300	1.0%	99.6%	315,657	
200000	89	0.3%	99.9%	832,210	
500000	16	0.1%	100.0%	1,767,867	
1000000	6	0.0%	100.0%	9,223,352	
	30,270	100.0%			

It is apparent by comparing income tax data with HM Revenue & Customs wealth data in this table that for those on very low incomes, apparent wealth is overstated by tax return declarations in proportion to expectation and for those on higher incomes apparent wealth reflected in tax returns is understated. At the very highest levels of income meaningful data cannot be extrapolated.

The only reasonable explanation for this anomaly is that there is clear evidence of income shifting by those with wealth from those who should be taxed upon the wealth derived from it at higher rates to those who are taxed on it at very low rates. Non working spouses and, maybe, children must be the recipients of this apparent largesse.

Calculating a precise sum involved is bound to involve approximation, as do the above tables, but by simply assuming that wealth is only reallocated to those with income levels up to £10,000 (at which point 22% tax is almost always going to be paid, reducing the attraction of shifting for many) then the result is that income is shifted and tax saved as follows (assuming those shifting all pay at 40%, as is, on balance, likely):

Income bracket	Wealth each	Likely wealth distribution per HMRC	Difference	Total	Rate of return	Income shifted	Effective tax rate on band	Rate otherwise due at	Tax lost
£				£mil			%	%	£mil
4745	11,113	2000	9,113	13,122	3.23%	424	1.1	40	165
6000	13,668	3000	10,668	12,375	3.23%	400	2.5	40	150
7000	18,706	4000	14,706	23,382	3.23%	756	3.4	40	277
8000	20,166	5000	15,166	44,739	3.23%	1,446	6.1	40	490
10000	21,968	15000	6,968	19,231	3.23%	621	8.5	40	196
						<u>3,646</u>			<u>1,277</u>

£3.6 billion of income is shifted and maybe £1.3 billion of tax is lost as a result of this one component of income shifting.

The figure might well be higher in practice for these reasons:

1. The rate of return used is the composite rate over both cash and share portfolios. Since those who are most likely to shift assets are more likely to own shares this rate of return may be understated;

2. The shifting of income from property is not noted in the above, but is likely to be actively undertaken and would suggest the apparent high rates of property income amongst those on low incomes. Over £1.2 billion of property income is declared by those in the income bands where income shifting appears to be a significant factor in income declared: the tax lost might be over £400 million as a result;
3. It is known from Treasury data published in the pre-Budget Report for 2007 that at least £250 million a year has been lost from income shifting between spouses within privately owned limited companies²²;
4. It is now possible to purchase pensions for non-earning spouses and even children. The effect cannot be quantified.

The result is that total income shifting is likely to exceed £2 billion per annum before the impact of shifting income to trusts and companies is taken into account.

The total impact of shifting income from self employed persons into companies has been estimated to be up to £1.2 billion per annum²³.

In 2004-05 approximately £1.1 billion was declared as income by trusts that might have enjoyed favourable tax arrangements²⁴, but since that time most income tax advantages from using trusts have been abolished and as such tax saved through income shifting to trusts is now likely to be small and is not considered further here.

Income shifted offshore is dealt with in the next section.

In total, based on this analysis income tax lost through tax avoidance from income shifting is likely to be not less than £3.2 billion per annum.

²² http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf page 164, accessed 1-11-07

²³ <http://www.taxresearch.org.uk/Documents/TRLLPSmallBusinessTax8-08.pdf> page 14 accessed 1-11-07

²⁴ <http://www.hmrc.gov.uk/stats/trusts/table13-2.xls> accessed 1-11-07