Principle 4

Remaining outside the scope of taxation

Introduction

One of the oldest tax planning principles consists of keeping either a taxpayer's income, wealth or transaction outside the scope of taxation, by refraining them from any transaction likely to generate tax liability (section 1). This applies to individuals as well as companies. Domestic economies illustrate this method and shall be examined separately (1.2). Various reasons justify the legislator in exempting certain taxpayers, income, wealth and even transactions. Listed under section 2, they also apply to principle 5 dealing with income deductions and tax rebates.

1. Avoiding transactions which generate tax liability

Transactions generating tax liability take countless forms according to the respective jurisdictions. They can be defined as "transactions or economic or financial situations related to the production, the circulation, the distribution and the consumption of goods. Sometimes, they are legal acts". They generate a tax liability. Henceforth our tax planning strategy will endeavour to avoid such transactions in order to remain outside the scope of taxation.

Sometimes, the transaction in question is an event outside the taxpayer's influence. Death for instance will generate inheritance tax. However, other tax generating factors can be influenced. One could thus avoid goods transiting through borders by opting for local production. Similarly, reducing the number of intermediaries will result in fewer incidences of sales tax. Renouncing to a place of residence or on the contrary deciding to become domiciled, resident (more rarely a national) in a given location, are decisions that will affect tax liability.

In other cases, the transaction generating the tax liability is a legal transaction deliberately effected by the taxpayer : sale, trade or gift. Tax planning will then rarely involve renouncing the transaction, but rather examining the type of transaction involved.

The transaction generating tax liability may also be an economic or legal situation present at a given point in time, as illustrated by the most common example : generating an income subject to direct taxation.

In principle, including an element in the accounts is enough to result in tax liability.

Finally, duration itself may generate tax : 30, 90 or 183 day periods often play a major part in local or international tax liability.

It would be pointless and unrealistic to attempt to draw an exhaustive list of all transactions to be avoided, firstly because certain legal transactions cannot possibly be avoided or systematically categorised in an advantageous manner, and secondly because tax incidences still rank second place in daily preoccupations.

1.1 Domestic economy

Our leisure society favours the development of the domestic economy, characterised by a taxpayer increasing his wealth by means of his own workforce. This process does not involve any event generating tax liability. It is likely that the increasing tax burden favours non professional vocations, since remaining outside the scope of taxation can generate considerable tax savings. Let us take for instance Mr Fix-It who is taxed (social and parafiscal charges included) at a 37.5% marginal rate. He wishes to build a garage in his garden. If he uses a professional, it will cost him $10,000.--. In order to afford this expenditure, he would need to earn a gross income of $16'000.--, subject to 37.5% taxes and social charges, i.e $6'000.--. Therefore, by building his own garage, Mr Fix-It will save CHF 16'000.-- and not $10'000.--.

Indeed, it might be an idea to take into account the quality of the work as well as the time, which might be better spent ! Moreover, most taxpayers receive a regular salary, which will be taxed in any event.

2. Tax exemptions

Given that the enrichment theory is one of the pillars of modern taxation, the tax authorities should, in principle, tax all type of material or immaterial goods. However, for several reasons to be listed below, the legislator has provided for exceptions, which can be numerous in some jurisdictions. The taxpayer may then decide, in all legality, to leave certain categories of income outside the scope of taxation.

These exemptions can be classified according to their respective justification.

- First of all, tax exemption for low income can be explained in terms of *social policy* considerations, especially when the tax authorities decide to levy tax only from a certain level of income upwards, in which case exceeding this level represents in itself a tax generating event. This is quite different from deductions, namely a certain amount, whether forfeitry or not, which the taxpayer may deduct from his taxable income, regardless of its importance. In the first case, full taxation only applies from a certain level upwards whereas in the second case, a deduction is allowed up to a certain amount. In practice, tax deduction can take the form of a forfeitry, deductible expense corresponding to the assumed vital minimum amount.

It is in the very nature of any tax system to contribute, to a greater or lesser extent, to a welfare state; The tax yield is anyhow very reduced in the lower taxable income range. On the other hand, the payment of any charitable contributions or gifts are logically tax exempt and even often tax deductible.

In *France*, besides tax deduction and exemption below a certain limit, global tax exempt net income varies depending on the number of persons who depend on the taxpayer.

In *Germany*, in 1997, vital tax free income was set at DEM 12,365.-- for single persons and DEM 24,730.-- for a couple. In 1999, these amounts will change to DEM 13,067.-- and 26,134.-- respectively. Tax wealth is levied on residents from DEM 120,000.-- and on non residents from DEM 20,000.--.

In *Belgium*, the first BEF 181,000.-- are tax free for single persons and the first BEF 143,000.-- for each spouse; additionally, a progressive sum related to the number of dependent children is deducted from the income depending on to the first income tier.

In the *United States* and in the *UK*, the tax exempt tier is extremely low, but deductions are usually more generous.

Social policy considerations also create several types of privileged income, such as certain pensions and national insurance benefits, redundancy pay (up to DEM 36,000.-- in Germany depending on the case). The tax authorities may sometimes grant fiscal incentives to particularly unpleasant or risky occupations (mining or working on offshore platforms) and to work performed at night, during bank holidays or on Sundays. Tax free university grants also fall in this category (in the United States, for instance).

- *Economic policy* measures may take many different forms and they often resemble social policy measures. In some tax systems, savings are encouraged through exempting returns on government loans, investment in small and medium companies or, more generally, in risk capital.

  Individuals domiciled in France benefit in 1998 from the following tax exemptions : income from a 'type A' or CODEVI savings account or from a popular or company savings account. Income and capital gains on securities investment accounts are also tax free, provided no withdrawal is made for 5 years. Withdrawal and redemption are totally tax exempt after the 5 year period, except for CRDS and CSG. Capital gains made at the time of transfer subsequent to closure of the account or withdrawals effected beyond the 8th year remain subject to income tax.

Revenues (including capital gains) from insurance policies held for over 8 years are also tax free. However, bonds and policies subscribed since 1st January 1990 for less than 8 years carry tax liability. The increase of social charges results in heavier taxation of life insurance policies. Unfortunately, this privileges are threatened to be reduced by the *Projet de loi de finance*.

In the *United States*, national and local government loans enjoy tax privileges. A further savings incentive is the tax exemption granted to capital gains resulting from provident funds contributions.

In *Great Britain*, the tax authorities publish regularly a list of government bonds exempt of income tax, some of which even escape inheritance tax.

Many further examples and comparisons can be found in the OECD Report on Income Tax Assessment for Individuals (Paris 1990).

Measures to encourage *the development of certain areas or economic branches* are also part of this category.

They range from full exemption (usually limited in time) to admitting amortisation or extraordinary expenses, granting generous loss reports, providing free infrastructure of technical support, etc.

In *France* for example, the economic development of overseas departments or communities is favoured through tax exempt investments. A project has been drafted to enhance job creation or maintenance.

In *Switzerland*, tax exemption is commonly granted to newly created companies.

In addition to the privileged status enjoyed by certain innovating or job generating companies, *Belgium* also allows tax deductions for new investments.

- Measures to encourage *home ownership* may include property tax exemption, but the legislator will usually do so by promoting building society accounts, as in *France* for instance. In *Italy*, renting out new buildings will carry a 50% reduction on property income.

- Environmental policy measures have developed over the past few years. In some jurisdictions, individuals will enjoy certain tax benefits for house insulation work and other energy-saving investments such as solar systems.

- The tax authorities may sometimes exempt gains for mainly *technical* grounds, when the amounts are too low, the collection expenses too high or the tax itself too easy to escape. This is why certain barters or payments in kind escape tax altogether.

  Capital gains exemption in, for example, *Switzerland*, makes it possible to do some tax planning based on income categorisation. In the *United States*, non domiciled individuals are only taxed if their taxable income exceeds USD 80,000.--.

- Finally, let us mention the *ethical* motives which may, in some tax systems, give rise to tax exemption, for example certain types of compensation received, as is the case in *Switzerland*, or motives linked to the conservation of property (art. 9, para. 3 LHID for instance).

Conclusion

The taxpayer will meet with several difficulties when attempting to remain outside the scope of taxation. First of all, he will need to keep an updated list of tax exemptions, as they are subject to constant change. Secondly, in order to maximise his tax exemptions, he will need to combine fiscal planning strategies such as postponing the fiscal burden , maximising deductions or recategorising the income.