Income tax returns are back in the news but as Herman Wouk, the prizewinning author of the Caine Mutiny quipped

Income tax returns are the most imaginative fiction being written today.

A little thought experiment.

Imagine if you went to your employer and said that you would be willing to forgo this year's pay increase. Instead you offered to give him or her $1 in return for paying you what you would have earned for the year, about 13 months from now.

Sounds totally nuts?

Not quite, provided that the lump sum down the road can legitimately be taxed as a capital gain rather than as salaried income. Right off the bat you would, provided that the documentation was watertight, be eligible for tax on only 50% of the amount . As a good citizen, you would of course pay all of the income tax due on the remaining 50% and 'save' a bundle.

There are risks. For example, the firm may go out of business and you would be a creditor way down the list. And, of course, you would have to live in the meantime. But for example, if you had some savings, sold your property at Sydney prices and downsized or even borrowed the money as you went along, at record low interest rates, it would be well worth it to 'save' the tax.

By far the biggest risk, however, is that the ATO would look at the scheme and judge that it was set up purely to avoid tax (which it was) and hit you with a large fine.

But let's take a less obvious situation. Suppose you 'assigned' your portfolio of shares (or better still the money to buy those shares) to an hedge fund manager in a blind trust and said - let's sign an agreement that says - don't buy or sell the shares and don't pay me the dividends, but instead pay me what the portfolio is worth one year from now plus a sum equal to the dividends in the interim.

Sounds totally nuts?

Not really. This is a so-called 'derivatives contract' known as a Total Return Equity Swap (TRES), and they are very popular. Investment managers love them because they don't have to do anything, merely collect the dividends. In the meantime, however, they do have temporary access to the dividends to play with, often using other derivatives to 'short' corporations and countries. Money makes money.

And, of course, the collected dividends are taxed as capital gains rather than as investment income. It not the income tax that you pay it's how you calculate that income.

Swaps are the philosopher's stone of global finance able to turn one set of cash flows into another set for all sorts of reasons, not merely 'tax efficiency'. And it is best if the financial alchemists perform their magic in the dark caves (or sunny climes) of tax havens, far away from prying tax authorities.

Sounds unlikely? Far from it.

Playing funny money with swaps is precisely what the Big Four Australian banks were found to have be involved in when they settled with the New Zealand Inland Revenue Department (IRD) in December 2009. The settlement of some A$ 1.7 billion, which was the largest legal fine/settlement in Australian banking history, resulted from the banks being found guilty by the New Zealand High Court of creating "tax avoidance arrangements entered into for a purpose of avoiding tax" using swaps to move money through murky tax jurisdictions.

Another example that has been referred to by the Labour opposition, is that of Mitt Romney, failed candidate for the US presidency, who had as it turned out had paid no tax at all on a very large share portfolio in offshore investment vehicles (hedge funds) located in exotic locations, such as the Cayman Islands. Just before the 2012 Republican convention, Gawker, a sort of American Crikey but bawdier, published some 950 pages of financial information that it had received, concerning Romney's financial affairs and those of his previous employer, Bain Capital. But while hiding money in offshore tax havens may be reprehensible, if you are Democratic, or prudent budgeting, if you are a Republican, it was not at the time illegal, provided that tax was fully paid on foreign income. It then becomes a matter of determining, what is income?

But Romney is not the only one to use tax havens. One example of how such swaps are used is by our very own Future Fund which is not subject to local taxes but is subject to tax on profits in some foreign countries. In a transaction involved in purchasing "distressed debt", profits were magically moved through a Total Return Swap from Luxembourg (a low taxing country) to the Cayman Islands (a no taxing country). Needless to say, the Future Fund management were aghast that anyone would even suggest that such a complicated transaction was done to avoid overseas tax.

Everyone is at it apparently!

But of course it's not everybody. It's only those who can afford tax lawyers, like PWC, and hedge fund managers to help skirt the boundaries of the law. It doesn't come cheap but is well worth the outlay, if the pot is big enough.

So the question is not, have you paid your income tax but how have you calculated that income tax?

And this question is about to come into sharp relief as governments around the world begin to address the rise of tax havens. Despite what may be considered a conflict of interest, at one level it's a positive for Australia that our prime minister is an ex-investment banker who is also fully aware of how tax havens work. On the other hand, he may be at a disadvantage because the ATO is shedding experienced staff just when they may be most needed.

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