



Will Scotland get its own income tax?

The minority SNP administration wants to replace council tax with a local income tax. *Raymond Kelly* assesses the implications for both employees and employers if it happens

One of the least-thumbed parts of the *Yellow Tax Handbook* is, one suspects, the extracts from *Scotland Act 1998*.¹ This was the legislation that created the devolved administration in Edinburgh and that, unlike other devolution legislation in the UK, included the power to vary the basic rate of income tax applicable to Scottish taxpayers in accordance with a resolution of the Scottish Parliament.

The permitted variation is an increase or reduction of the basic rate of income tax by no more than three pence. It does not apply to any other rates nor to any other taxes and,

since the Scottish Parliament first met, there has never been the least likelihood that the devolved administration would actually seek to exercise these powers. The legislation is, therefore, on the statute book but has so far never had to be applied in practice.

In the Scottish Parliament elections of 2007, the Scottish National Party emerged as the largest single party but without an overall majority. It has since governed as a minority administration, obtaining support from other parties on individual issues. The manifesto under which the party fought its election campaign included a commitment to scrap

what is described as the 'unfair council tax' and to replace it with a local income tax set at a figure of three pence.²

Early in 2008 the Scottish Parliament issued a consultation paper entitled 'A Fairer Local Tax for Scotland'.³ This was based on the Scottish National Party manifesto commitment to replace the existing council tax, taking it for granted that that current property-based tax is unfair, and proposing the imposition of a 3% tax on the income that is subject to the basic and higher rates of tax, with an exemption for savings and investment income.⁴ The complete abolition of property-based tax is,

however, avoided because a tax on second homes would remain. It is also proposed that Scotland would adopt the same personal allowances as exist under the UK system, so that an individual could not find himself liable to Scottish tax on his earnings while his income for UK purposes is covered by personal allowances.

There are some uncertainties, however, that would need to be resolved as the legislative process develops. One point that comes to mind is whether reliefs that are derived from other than activities that may give rise to earnings can be set off against earnings subject to the tax. For example, *Income Tax Act 2007*, s. 132 allows for certain capital losses on share disposals to be relieved against income. Would such a relief be permitted under the Scottish tax, or could a claimant to such relief effectively find himself liable only to the 3% Scottish charge while his UK liability is eliminated?⁵

How far these proposals will advance is at present wholly uncertain. The administration is a minority one, not currently able to push legislation through without support from other parties. It should be noted, however, that the Liberal Democrats also favour a local income tax, albeit with some significant differences from the proposals outlined in the consultation document.

Were these proposals to find their way on to the statute book, it would give Scotland a very different tax profile from the rest of the UK.⁶ As far as individuals are concerned, other than in respect of second homes and the prospect of inheritance tax liability for those of sufficient wealth, there would be no tax on ownership of assets. It is not immediately obvious that taxing income rather than assets is a 'fairer' system of tax, and there appears to be a basic confusion of thinking that mixes fairness with the ability to pay and assumes that the ability to pay is determined by the ready availability of cash derived from income. One might speculate as to whether, were the Scottish National Party to realise its ultimate goal of an independent Scotland, it might regret that it had restricted the scope of its tax-raising powers by its denunciation of asset-based tax. The council tax, as currently structured, may justifiably be regarded as regressive, but it would not be beyond the capacity of legislators to devise an alternative that achieved a much greater level of equity.⁷

One might also reasonably observe that, if ability to pay is the main criterion for fairness, the decision to exempt savings and investment income makes little sense.⁸ The consultation paper does, indeed, say that this exemption is driven not by equitable considerations but because the Scottish government believes that the cost of collecting tax on savings and investment income may exceed the amount of money that would be raised.⁹

One might reasonably observe that if ability to pay is the main criterion for fairness, the decision to exempt savings and investment income makes little sense

As far as advisers are concerned, the arrival of the Scottish income tax on the statute book would create some new issues for consideration. Up to now, advisers have not generally had to advise on council tax. It did not throw up much in the way of technical issues, the main area of potential dispute being the band of value into which an individual property may fall. However, once the local taxation system is based on income, the practitioner will need to be acquainted with the issues that will arise in respect of the new tax.

The focal point will be to determine who falls within the charge to the tax. The current proposal is to apply the definition of a Scottish taxpayer at *Scotland Act 1998*, s. 75, ie, the same definition of taxpayers subject to the tax varying power should it ever be invoked. Section 75(1) provides the basic definition, composed of two tests in relation to any year of assessment:

- a) He is an individual who, for income tax purposes, is treated as resident in the UK in that year, and
- b) Scotland is the part of the UK with which he has the closest connection during that year.

Although the first of these is clear-cut, it means that non-residents' earnings from employment undertaken in Scotland will not be subject to the Scottish tax. An individual seconded from abroad to work in Scotland for a period of, say, five months, would be subject to UK income tax¹⁰ on his earnings but would not be subject to the Scottish charge.

The more complex part of the definition is the determination of whether the individual has had his closest connection with Scotland or with another part of the UK. It is worth noting that this is an all-or-nothing test for the year of assessment. The whole year is taken into consideration and, if the test is passed, all earnings in the year will fall within the scope of the Scottish tax, even those received before the Scottish connection began. If the test is not passed, none of the earnings received in the year will be subject to the Scottish tax. For those employees who might be moving to or from Scotland in the course of their working lives, there could be significant benefits or costs depending on exactly when they receive bonus payments or exercise options under share-incentive schemes.

This also gives rise to the possibility of either double taxation or double non-taxation. As

the rest of the UK will be subject to a property-based tax that ends or starts not by reference to a year of assessment but to the actual ownership of the property, there could be a year in which an individual is subject to the Scottish tax as having been in Scotland from April to October, sufficient to bring his whole earnings in the year within the ambit of the Scottish tax, and is then resident elsewhere in the UK from October to the following April, paying council tax for that six-month period.

There are three tests of whether an individual has his closest connection to Scotland in the course of the year. One group automatically included, regardless of the extent of their presence in Scotland during the year, is members of the Scottish parliament and representatives of Scottish constituencies in either the UK or European parliaments.

The other two tests both require presence in Scotland. The simpler of the two is that the number of days spent in Scotland is equal to or exceeds the number of days spent elsewhere in the UK. For this purpose the location of the individual at the end of the day is determinant of his location for the day.¹¹ One looks forward to the first debates as to where exactly the overnight sleeper train was at midnight and, indeed, what the effect of its running late on any specific day might be.

The final test requires the taxpayer to have been present in Scotland for at least part of the year and that his principal UK home (which he makes use of as a place of residence during the year) is located in Scotland for at least as long as his principal UK home is located outside Scotland. As a 'place' is specifically defined to include a place on board a vessel or other means of transport¹², this would appear sufficient to encompass those who live on houseboats. It would not extend to those who spend a significant part of their time on North Sea oil installations as, although these include the sleeping quarters for those who are on rotational work, these could not be regarded as a home and, therefore, not as a place of residence.

As far as workers who carry out their duties on offshore installations are concerned, the definitions of UK¹³ and of Scotland¹⁴ extend only to the land area and the related territorial sea. The majority of offshore installations are outside the territorial sea but within the continental shelf area and do, therefore, fall outside both definitions, so that time spent on these would not count towards the physical

presence test as either Scottish or UK presence. In respect of installations within the territorial sea area, however, nights spent thereon would have to be taken into account in determining whether an individual is to be regarded as a Scottish taxpayer.

An issue that is not addressed in the consultation document is whether the Scottish tax would be regarded as a tax for the purpose of the UK's double taxation conventions. As a general rule, one would expect that the answer would be in the negative. There is no suggestion of any provision that would allow relief for any foreign tax suffered on any income subject to tax under the Scottish income tax legislation, even if the UK tax on that source of income had been insufficient to absorb all of the foreign tax suffered.

As far as the reverse scenario is concerned, the restriction in Scottish tax liability to those who are resident in the UK means that cases in which relief might be sought overseas would be limited.¹⁵ However, the definitions of taxes covered in most of the UK's double taxation conventions are phrased so as to envisage national taxes only, so automatic tax treaty relief would not be available overseas.

As mentioned above, the exclusion for savings and investment income is driven not so much by a quest for fairness and equity but by the perceived complexity of collection. It is envisaged that the Scottish tax can be collected through the dual processes of PAYE and self-assessment. While one can see quite easily how this would work under self-assessment, with the taxpayer ticking a box on his return to state that he is a Scottish taxpayer, the use of PAYE as a collection mechanism may prove to be fraught with practical problems.

By and large the principle of PAYE coding should be able to cope, as all the earnings will be subject to tax, including any benefits dealt with through the coding system. The use of coding to deal with any matters outside the taxation of earnings would, however, appear to create significant practical problems: there are effectively differential rates of tax on earned income and other income. The major difficulty employers will face, however, is the identification of those to whom the Scottish tax charge is to be applied so that they can be taxed by reference to, one would presume, a different set of tables with a 3% higher tax rate.

The consultation document is disappointingly thin on this issue. It does admit that the different income tax is 'an issue' and that employers will have to apply different rates to their employees who live in Scotland, ignoring the fact that living in Scotland is not the sole test of whether someone is a Scottish taxpayer.¹⁶ If the system is to work at all, the employer will have to be under an obligation to

determine if the employee is a Scottish taxpayer to whom he has to apply the differential rate of tax. The obligations on employers are already sufficiently onerous without requiring them to understand and apply the tests of presence and residence, which would itself involve asking detailed questions about aspects of their employees' lives. It must, therefore, be for the employee himself to advise the employer that he is a Scottish taxpayer, even in advance of knowing for sure that he is, given that determination of status is made in arrears, so that the correct PAYE can be applied.

Will we, therefore, find ourselves in a situation in which every employer in the UK is under an obligation to ascertain from each of his employees at the start of each year whether he expects to be a Scottish taxpayer for that year? Alternatively, will the legal obligation be on each employee who expects to be a Scottish taxpayer for the year to advise his employer accordingly? One or other of these scenarios must apply, backed by an enforcement mechanism, and, given that the status of Scottish taxpayer can be no more than an expectation until, at the earliest, October,¹⁷ it is difficult to envisage an effective penalty system for non-compliance.

There are other administrative areas that will have to be addressed. For example, there is the appeal mechanism. Presumably the Scottish tax will ordinarily piggy-back on to the UK appeals system, so that the determination of whether something is taxable income will be subject to a normal UK appeal, the decision on which would be binding for Scottish tax purposes. However, there will have to be the capacity to appeal against the status of a Scottish taxpayer.

Various bodies have responded to the Scottish government's consultation document.¹⁸ It remains to be seen to what extent the various concerns expressed will be taken into account in the final legislation when it comes forward. Even then, there is, of course, no guarantee that a minority administration will be able to ensure that the legislation is passed. However, the possibility is very much alive that Scotland will have its own income tax, and all practitioners, not only those based in Scotland but those advising employers who may employ Scottish taxpayers, will have to be ready to advise on the consequences for their clients.

Raymond Kelly is technical tax director of John Wood Group PLC and chairman of the Scotland Branch of the CIOT (Raymond.kelly@woodgroup.com).

The observations in this article are the author's and not necessarily the views of John Wood Group PLC

1. To be found at pages 2333-2336 of the 2008-2009 edition.
2. Page 20 of the SNP 2007 manifesto. Rather bizarrely, the manifesto goes on to say that '[t]his will apply at both the basic and higher income tax rates', implying, quite wrongly, that this is an exercise in tax-varying rather than the imposition of a separate liability.
3. To be found at www.scotland.gov.uk/Publications/2008/03/11131725/20.
4. For convenience I have used the term 'earnings' throughout in relation to the income that it is proposed be subject to the Scottish income tax.
5. Another thought that occurs is whether non-domiciliaries could continue to benefit from the remittance basis in respect of appropriate earnings. Will Scotland have an equivalent of the £30,000 annual charge?
6. Another obstacle is the view, expressed by the Treasury, that a Scotland-wide income tax would be *ultra vires*. This is not considered further in this article.
7. Most of the states that make up the USA derive their income from a mixture of income tax (normally based largely on the same income base as the Federal tax), sales tax (under EU law, Scotland cannot vary the rate of VAT, a restriction that would be ended by independence) and property tax. Although one could argue about the split between these sources, it appears to the writer that a fair tax system is one that raises its revenues from each of these categories.
8. As does the omission of chargeable gains.
9. 'A Fairer Local Tax for Scotland', at para 17.
10. Assuming he is not exempted under a double taxation convention. If his earnings are being paid or borne by a UK resident employer or a UK permanent establishment, he will not be able to benefit from such an exemption even if the secondment is less than the normal 183-day limit found in most conventions.
11. Those who drafted the *Scotland Act* thus set the precedent for the provisions of *Finance Act 2008*, s. 24.
12. *Scotland Act 1998*, s. 75(6).
13. *Income Tax Act 2007*, s. 1013.
14. *Scotland Act 1998*, s. 126(1).
15. Primarily cases of dual-resident individuals whose residence for double tax conventions is held to be abroad under the treaty tie-breaker provisions.
16. 'A Fairer Local Tax for Scotland' at para 29.
17. Except in the year of death.
18. The CIOT response can be found at www.tax.org.uk/showarticle.pl?id=7048;n=3794.