Scottish Parliament
Finance Committee

A Scottish approach to taxation: call for evidence

Evidence from ICAS

30 September 2016

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About ICAS

1. The following submission has been prepared by the ICAS Tax Committee. The ICAS Tax Committee, with its five technical sub-Committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.

General comments

2. ICAS is grateful for the opportunity to give evidence to the Finance Committee regarding its inquiry into 'A Scottish approach to taxation', as requested in the call for evidence issued in July 2016.

3. ICAS has contributed the experience of its members and their technical expertise in the development and implementation of the two existing devolved taxes, Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT), in the development of the proposed Air Passenger Duty, and the establishment of the new tax authority Revenue Scotland. ICAS has also contributed to the development of both Scottish Rate of Income Tax and the forthcoming Scotland Act 2016 measures.

4. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members into the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

5. The Scottish Government has set out its overarching principles but we believe that there is a need to distinguish between very high level principles and objectives. In broad terms, it needs to be decided what the objectives of tax raising are and the balance between them. So, for example, the key objectives are likely to be to raise funds, bring accountability, support other policies such as economic growth, and redistribute resources. These need to be decided, ranked in order of importance, and they can then be married up to the four overarching principles. It also needs to be recognised that the objectives and the achievement of the four principles may differ with each different tax. Furthermore, the principles may need to be balanced with each other as they sometimes conflict.

6. There are of course other principles that may be considered appropriate as part of a 21st century tax system and these are detailed below under question 1.

7. There are also other themes that the Scottish Parliament may wish to promote, such as being strong on anti-avoidance, or bringing a greater awareness of Scottish taxes to the taxpaying public. The approach to taxation may also be multi-layered, for example, with international and national levels that address different elements and this is discussed below at paragraph 27.

8. ICAS recommends that there should be a clear, brief statement of the principles and objectives, a longer term plan, perhaps a five-year plan, and an indication of the basis on which stakeholders are expected to participate in the Scottish approach to taxation. As with the Charter issued by Revenue Scotland, such a statement could be subject to public consultation and then published. The benefit of this approach would be to give more certainty to taxpayers. Uncertainty is bad for business and economic investment.

9. As part of the overall approach to taxation, there should be sound financial processes that provide useful and meaningful financial information. Such financial information is needed to allow a better understanding of tax policy and tax collection and how these have been used to support public finances. It will also enable taxpayers to hold decision makers to

account. Another important part of this overall approach is being able to analyse devolved revenues against budget to assess whether policy decisions have achieved their intended effect.

10. There need to be sound intergovernmental relationships, given that the main source of tax revenue to Scotland is income tax, which has been partially devolved. Partially devolved taxes involve joint responsibilities. Political responsibility is split between the UK and Scottish Parliaments. The UK Parliament is responsible for the tax base, ie what is considered to be income, and how it is measured. The Scottish Parliament is currently responsible for Scottish Rate of Income Tax (SRIT), as provided for in the Scotland Act 2012. In future, with the Scotland Act 2016 income tax powers, the Scottish Parliament will be responsible for the rates and the bands, allowing it to exert much greater control over how much is assessed for collection and from which taxpayers.

11. Administrative responsibility remains with HMRC but the Scottish Government will pay any additional costs of collection. This may require intergovernmental machinery, which requires a delicate balancing act, resting upon respect, trust and common interests. The machinery needs to be designed in order to facilitate the sharing of powers between different governments and their respective tax authorities. Inter-governmental machinery is assisted when the terms are laid out in memorandums of understanding that are principles-based to provide clarity and transparency. It is also best served by appointees who understand both governments and who can establish the common interests, aims and objectives.

12. Intergovernmental relations would also be strengthened if there was a coordinating body, so that the devolving of powers, for example to Scotland, Northern Ireland and Wales, could be coordinated and also so that individual devolved tax authorities may learn from sharing experiences in a formal, coordinated forum.

13. We also call for a process that allows for regular maintenance of the taxes, and we hope that this will be considered as part of the Review of the Budget Process. One aspect of this should be formalising a regular timetable and process for stakeholders to give input on any operational and policy concerns with the tax legislation.

14. In the UK there is a clear division of responsibility between policy in HM Treasury, and operational matters in HMRC (although this includes policy in relation to care and maintenance of operational taxes). However, in Scotland the Scottish Government appears to have sole responsibility for policy. The unknown, untested element in Scotland is whether Revenue Scotland and HMRC will develop a policy role in care and maintenance. Also, how will Revenue Scotland, HMRC, the Scottish Fiscal Commission and the Office of Budget Responsibility and others contribute to policy development in Scotland through provision of experience and data?

Question 1: How can the Scottish Government's four principles to underpin Scottish taxation policy best be achieved?

15. At the outset it should be recognised that it may not be possible to create a tax policy that fully achieves all four principles, in part because they can conflict with one another and often a balance will need to be drawn.

16. In order to achieve the four principles there needs to be clarity of purpose around the objectives of taxation and the extent to which the different objectives are balanced against one another. For instance, is Scottish taxation policy aiming to raise funds, drive the economy, redistribute wealth, drive particular behaviours, and/or provide accountability?

17. In deciding these it should be borne in mind that the objectives behind income tax may differ from those behind transactional taxes, or their weighting may differ. For instance, income tax tends to be the main lever for income redistribution purposes whereas this is less the case with transactional taxes.

18. In our view the following could be used to assess the options which might support the key principles:

- Proportionate, reflecting ability to pay
- Simple to understand and transparent
- High collection rates, predictable revenues and difficult to avoid
- Clear accountability which connects decision making and spending of public funds with taxes raised
- Cost effective to administer
- A broad but balanced tax base
- Best value (that the government should not take more than it needs or be profligate with public funds)
- Stable and predictable revenues
- Aligned with current, not historic, needs and priorities
- A basket of taxes to minimise overloading one form.

Question 2: How does the current taxation regime and proposals for newly devolved taxes align against these four principles?

Be proportionate to the ability to pay

19. The principle of 'ability to pay' is generally viewed as a proportionate rise in tax rates as income increases, although this can be less clear cut in transaction based taxes such as LBTT or APD. Further, in relation to LBTT, the operation of this principle can be undermined by behavioural changes such as fewer purchases of property; the principle itself may undermine other objectives such as stimulating the economy. This needs to be recognised, and balanced, in the matrix of policy objectives.

20. Depending on which tax is being considered, there may also need to be further articulation of 'proportionate to the ability to pay'. The term 'ability to pay' is subjective and needs to be refined, for example, in relation to local council tax and whether it is to reflect gross income only, disposable income or income less essential expenditure; or the term 'ability to pay' may be wider and judged against a combination of income and capital. As noted in evidence to the earlier inquiry into LBTT, this tax is better aligned to 'ability to pay' than the earlier SDLT. Ability to afford a more expensive property may give a strong indication of a greater ability to pay tax but, for those with a mortgage, increasing tax usually means reduced funds available to purchase the property.

Provide certainty to the taxpayer

21. One of the four principles is 'certainty', which in our view includes both simplicity and stability. To provide certainty it would be helpful if a relatively long term view could be taken with a minimum number of changes to the thresholds and rates over time. This will enable taxpayers, both individuals and businesses, to plan ahead with confidence. Certainty is also important to encourage economic investment; business will not invest if the tax treatment is uncertain. Examples of where there is relative certainty may be found with council tax and business rates. Examples of where there is less certainty can be found with the unexpected introduction of Additional Dwelling Supplement, or in income tax where there might be uncertainty over Scottish taxpayer status in some instances.

Provide convenience/ease of payment

22. We consider that the payment and administrative processes for LBTT provide convenience, particularly in comparison with previous SDLT systems.

Be efficient

23. Income tax for the majority of taxpayers is collected by way of PAYE, a system designed to collect tax efficiently, and this will remain the case for Scottish income tax.

Question 3: Is there scope for a fundamentally different approach to taxation in Scotland?

24. This question is closely linked to question 5 below. The Scottish Parliament has the power to take a fundamentally different approach, however the practical implications of this could be dramatic and unpredictable.

25. There are also challenges in adopting a fundamentally different approach, most of which result from comparison with tax in the rest of the UK. Such challenges may include:

    - The burden of taxation leading to behavioural changes. It has been noted before that there are only a relatively small number of additional rate payers in Scotland and if even a few choose to move to the rest of the UK or, say, incorporate then there is no, or little, benefit for Scotland from seeking to raise income tax at the upper end of the income spectrum
    - UK wide businesses may choose to prioritise their operations outside Scotland if there is a perceived tax or administrative cost of transactions in Scotland
    - Taxpayers familiar with the current system that has evolved over a long period may react negatively to fundamental changes, which introduce uncertainty and are therefore unlikely to encourage economic investment
    - Radical changes to the taxation system in Scotland might result in economic growth but the additional yield may arise in non-devolved taxes, such as corporation tax or capital gains tax. The potential to make radical changes may be limited because Scotland has only 'half the Lego set'
    - Administrative cost is generally underestimated, for example, the cost to business of updating systems to deal with changes.

    These challenges should be considered in conjunction with any decision to make radical change to taxes in Scotland.

26. A Scottish approach to taxation may have a number of distinctive features, such as a layered vision, setting out a longer term strategy, and stating the key tax policies.

The tax vision

27. This may benefit from a 'layered' vision that addresses different levels:

    - International - this might consider whether:
        - Scotland wants to be seen as a good example and set agendas
        - Scotland wants, or does not want, a reputation as a tax haven
    - National/ macro level - this might consider:
        - How it will work with the rest of the UK
        - What signals tax competition gives to investors and to other parts of the UK
        - The stance on tax avoidance
    - The legislative level - this might consider what type of legislation is most appropriate:
        - Principles *versus* prescriptive legislation
        - GAAR *versus* TAARs
        - Primary *versus* secondary legislation.

Development of, and a need for, a 'roadmap' and tax policy principles

28. Policy is more likely to be better thought out if it is designed over the medium to longer term. ICAS believes that a roadmap, for example over 5 years, to set out the objectives of Scottish tax policy is vital: this should set out policy objectives and provide clarity of purpose. A roadmap may also discourage politicians from indulging in eye-catching changes that may offer a perceived short term political advantage but that may not meet the test of benefit over the longer term.

29. Other considerations may include statements on how often tax policy changes should be proposed or how often rates and bands should change, given that taxpayers and business want certainty and stability.

30. Tax policy principles should include public messaging, an articulation of when Scottish policy is to be distinctive and when it might follow UK measures, the need for evidence to support policy making, and the role of tax reliefs.

31. Part of the wider policy remit is to provide clear messaging because uncertainty drives away investment and certainty around intent is needed. So, for example, the overarching principle of LBTT is that it is on a progressive basis. This is helpful, it guides taxpayers.

32. Because of the way in which Scottish taxes interact with other UK taxes consideration needs to be given to ensuring that there are processes and procedures in place to protect against the impact of changes elsewhere. This would be the case if in future the personal allowance was to be increased at UK level, which would impact on revenues/Scottish income tax collected. Or, if there were changes, such as happened with the introduction of the SDLT additional dwelling supplement. How should the Scottish Government respond: wait, evaluate and then decide how to proceed, or simply replicate? A policy approach to this is needed. A stated position should be in place about the circumstances in which Scottish tax policy should seek to follow the UK, and to set out the parameters of when a different policy is to be maintained.

33. Policy makers also need evidence to inform policy making, for example, is there evidence to support the contention that the Scottish buy-to-let market would have changed without ADS being introduced?

Tax reliefs

34. The role of tax reliefs in any Scottish tax system needs careful evaluation. If there is to be a strong stance against tax avoidance legislators should not provide incentives for undertaking it, as can happen with the introduction of reliefs. Careful consideration needs to be given to proposed new reliefs. Other points to consider in relation to reliefs:

- Should there be reliefs and, if so, for what purpose?
- When and how will their effectiveness be evaluated?
- Will there be sunset clauses?
- How do you prevent reliefs becoming avoidance mechanisms?
- Do they then become unduly complex?
- What are the alternatives – grants?

A stakeholder strategy

35. There should be a clear, long term strategy for the Scottish tax system which includes its stakeholders and taxpayers. This would need to include a commitment to the following:

- The law must work properly
- High standards of behaviour are required all round
- Good public information is needed
- Tax policy needs clarity
- Businesses need to be transparent
- A clear stance on tax avoidance should be articulated.

Question 4: Should future tax changes be ring-fenced and if so, how? If not, why?

36. ICAS does not agree with the notion of hypothecating taxes. There are both philosophical and operational aspects to consider before going down this route.

37. If taxation is levied for the common good, all funds should be collected and then decisions made about their use. Hypothecation implies that the taxpayer is simply paying for a particular item or service. Following this logic, taxpayers should only pay for what they use and this undermines the notion of contributing to the common good. It also limits flexibility for government policymakers.

38. From an operational aspect, restricting funds to the provision of certain goods or services is limiting, adds to the administrative burdens, and reduces flexibility around spending decisions.

Question 5: To what extent do potential behavioural responses limit options for tax changes in Scotland?

39. There are perhaps two issues to consider. One is the expected potential behavioural responses, which can be modelled and planned around; the other is that there can be unintended consequences of tax change, which can be significant. For example, the consequences of the new LBTT are still being established and it remains to be seen whether there are either behavioural responses and/or unintended consequences of having changed to a progressive rate structure.

Complex interactions and behavioural aspects

40. Consideration of tax devolution and the exercise of the devolved powers requires recognition of the fact that the different components in the Scottish and UK tax systems are intricately intertwined. Some outcomes can also be determined by taxpayer choice, so that the main taxes cannot be considered in isolation, nor can income tax be viewed separately from other policies or matters such as national insurance contributions. For example, aspects of the existing taxation of employees, the self-employed and small companies can lead to tax planning and influence behaviour because of:
    - the differential in income tax and NIC costs for employees compared with the self-employed,
    - the differential in tax rates, combined with the different timings of payment, between income tax for the unincorporated business and corporation tax for the incorporated business,
    - the decision to extract profits by way of salary or alternatively as pension contributions or dividends, and
    - the different tax consequences arising from receipts of income and receipts of capital.

41. When only some elements are devolved, this opens the way to greater complexity, wider differentials and increased attempts at planning to avoid increased tax costs. The devolving of income tax rates and bands will be likely to result in different rates being applied in different parts of the UK. This may lead to more local accountability between tax and spend. It may also influence taxpayer behaviour. For instance, if income tax becomes more expensive taxpayers may seek to convert sources liable to income tax into something else that is liable to, say, corporation tax or capital gains tax. Both CT and CGT are reserved taxes so any increase in receipts will flow to Westminster.

Competition

42. Behavioural responses may limit some options; equally behavioural responses may not be limiting if the policies are considered attractive. This could be by offering an attractive tax rate, such as reduced Air Passenger Duty, thereby encouraging more travellers through Scottish airports. However, care needs to be taken in setting a tax competitive policy, particularly if it is an aggressive competition policy, because it may give a broader message to neighbouring jurisdictions that is unattractive. It may also simply lead to further competition, 'a race to the bottom' and ultimately to falling revenues for everyone.

43. If neighbouring jurisdictions introduce a relief that is competitive, does Scotland need to do likewise to protect commercial opportunities (e.g. LBTT/SDLT seeding relief)? This needs to be analysed in relation to the overall strategy as discussed in question 4; international tax avoidance behaviours would potentially appear within the UK for the first time.

Question 6: To what extent do the mechanisms for administering the Scottish income tax system via HMRC limit the scope for a different tax system in Scotland to develop?

44. In our view it is the powers that have been devolved, covering rates and bands only, that are the limiting factor.

45. PAYE is an efficient way to collect income tax and this will remain the case when, through the Scotland Act 2016, income tax rates and bands are devolved.

46. There are some elements of income tax administration which do not easily lend themselves to the new devolved arrangements, such as gift aid or pension contributions. We understand that a pragmatic approach is being adopted to the implementation of Scottish income tax rates and bands, which we support.

47. We also understand that HMRC considers that it can cope with changes that might arise from the current powers, so it is unlikely that HMRC would be a limiting factor. However, there could be a potential conflict of interest if, say, identification of Scottish taxpayers differed between Westminster and Holyrood. That though is different from limiting the scope of a different tax system.

48. Beyond this, there are a number of changes underway in HMRC which will inevitably impact on resources to administer Scottish income tax. With a strong focus on the digital transformation programme, ongoing staff reductions and the reorganisation into 13 regional centres there is unlikely to be much capacity to focus on devolved administrative processes.

49. HMRC staff hold ongoing meetings with the Scottish professional bodies, and others, to discuss 'S' tax codes and the operation of Scottish taxes.

50. The impact on employers also needs to be borne in mind: most income tax is collected through PAYE and this is undertaken by employers. They are unlikely to welcome any changes that increase their administrative burdens.

Question 7: Are there any other administrative limitations to the emergence of a Scottish tax system?

51. The administration of taxation reflects the tax powers that have been devolved and, as discussed in question 6 above, the key limitations are around the powers.

The business sector

52. The business sector faces an escalating compliance burden for taxes as HMRC transforms itself into a digital tax authority and increases its requirement for businesses to administer and collect taxes in real time. This is already the position for VAT, PAYE and NIC.

53. The challenges for SMEs in tax collection include:
    - Complexity
    - Change
    - Obligations and penalties
    - Dealing with the tax authorities
    - Mandatory digitalisation.

54. Addressing these challenges and keeping matters simple means recognising that:
    - Administrative ease is all-important
    - Frequent changes add to complexity
    - Using tax reliefs to incentivise behaviour may lead to lengthy, difficult legislation
    - Working closely with the UK authorities is vital to ensure that tax is kept as streamlined as possible, whilst implementing the devolved tax powers.

55. The introduction of the Scottish Rate of Income Tax on 6 April 2016 did not unduly affect employers, as HMRC was responsible for identifying and determining who is a Scottish taxpayer. The Scotland Act 2016 income tax changes should not be significantly different in their impact but employees are likely to regard their employer as the initial source of information if they have queries, given the service problems with HMRC helplines and HMRC's policy of discouraging contact from Scottish taxpayers.

56. The approach by the UK Government over the last decade has been to make businesses more directly responsible for collecting taxes – building on the VAT and PAYE systems which have operated so successfully in the UK for many years. The changes have included the introduction of Real Time Information (RTI) for PAYE, the administration of

the national minimum wage, pensions auto-enrolment, and changes to VAT place-of-supply rules. The public finances are heavily dependent on this work by businesses as unpaid tax collectors. Care is required not to overburden businesses.

Taxpayer understanding

57. Other limitations are around taxpayer understanding. First, with a package of fully devolved, partially devolved, assigned and local taxes, many of which have different implementation dates, we question whether there is widespread understanding of 'Scottish taxes'.

58. Secondly, income tax is collected from the vast majority of taxpayers through the PAYE system operated by employers. Taxpayers simply receive the net sum. PAYE is designed to collect tax in as efficient a way as possible so income tax for employees is not as visible as other taxes where an amount has to be paid over. It 'plucks the goose with as little hissing as possible'. It is not designed to be seen, and therefore is unlikely to be seen as part of a Scottish tax system. Clearly, such lack of visibility will be compounded if Scottish income tax rates are the same as UK rates.

59. The Scottish income tax rate(s) will be applied to earned income, pensions and rental income, but not to savings income and dividend income (to ease administrative pressures and avoid distortions of the UK savings market).

60. If income tax rates and thresholds in Scotland diverge from those elsewhere in the UK from April 2017 onwards, clear explanations and guidance will be needed to reassure taxpayers, provide transparency and certainty, and discourage unintended behaviours.

The fiscal framework

61. Whilst tax policy can be made more transparent, there is an inherently opaque feature of the overall Scottish funding arrangements and that is the Fiscal Framework. Until it is seen how this operates in practice then there must be uncertainty as to how a Scottish approach to taxation will impact on the available funds.