**Scottish Parliament**
**Finance and Constitution Committee**

**The Scottish Budget**
**Call for evidence**

**17 December 2018**

## About ICAS

1. The following submission has been prepared by the ICAS Scottish Taxes Committee on behalf of the ICAS Tax Board. The Tax Board, with its five technical 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.

2. 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.

3. 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 in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

## General comments

4. ICAS is grateful for the opportunity to contribute its views on the Scottish Budget, as requested by the Scottish Parliament's Finance and Constitution Committee.

5. We have restricted our comments to matters in our area of expertise, which is the operational aspects of taxation.

6. We were pleased to meet with the Cabinet Secretary for Finance, Economy and Fair Work, along with a number of tax stakeholders, prior to the budget in order to discuss aspects of potential tax changes.

7. Devolution has introduced new opportunities, but also new complexities, with many moving parts to manage – with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions. We have discussed this in a recent paper *Devolving Taxes across the UK: Learning from the Scottish Experience*[1].

8. We welcome the timing of the UK budget this year in relation to the Scottish budget – but believe the timing of the budgets in each jurisdiction should be governed by a more formal process that is designed to enable maximum collaboration between governments.

9. We have commented below on the specific points raised in the call for input.

## Key budget changes in Scottish income tax (SIT) for 2019/20

10. The rates and bands for 2019/20 are as follows:

| Band 2019/20 | Band 2018/19 | Band Name | Rate 2018/19 and 2019/20 |
|---|---|---|---|
| £12,500–£14,549 | £11,850–£13,850 | Starter rate | 19% |
| £14,549–£24,944 | £13,851–£24,000 | Basic rate | 20% |
| £24,944–£43,430 | £24,001–£43,430 | Intermediate rate | 21% |
| £43,430–£150,000 | £43,431–£150,000 | Higher rate | 41% |
| Over £150,000 | Over £150,000 | Top rate | 46% |

Note: assumes the Scottish taxpayer has a UK personal allowance of £12,500 (reduced by £1 for every £2 of adjusted net income over £100,000).

Further points to note:

- The personal allowance is UK-wide and cannot be changed
- The starter and basic thresholds increase by inflation whereas the higher rate threshold is frozen at £43,430.

[1] https://www.icas.com/__data/assets/pdf_file/0012/388497/Devolving-taxes-across-the-UK.pdf issued by the Scottish Taxes Policy Forum, a joint collaboration by ICAS and the CIOT

**Tax policy divergence between Scotland and the rest of the UK**

11. Scottish taxes do not sit in isolation – they are interwoven within the UK tax regime and there are connections and constraints which this imposes. One particular example is the personal allowance which is set by Westminster and applies to all UK taxpayers with the effect that a significant proportion of the Scottish population are lifted out of income tax (44.6% in 2019/20[2]), in turn making the Scottish taxpaying base smaller.

12. The numbers around the Scottish taxpaying population include:

- 44.6% of adults in Scotland will not pay income tax in 2019/20.
- There are 2.5 million income taxpayers in Scotland.
- A Scottish taxpayer earning £25,000 will be £140 better off in terms of income tax (primarily due to the UK-wide personal allowance increase).
- Around 99% of Scottish taxpayers will pay less tax in 2019/20 than in 2018/19 (those who pay more are above the threshold where the personal allowance is withdrawn).
- Taxpayers in Scotland and England will pay the same tax on earnings of £26,993.
- Between £43,430 and £50,000, Scottish taxpayers will pay a combined marginal rate of 53% (41% SIT and 12% NIC).

**Behavioural responses**

13. Two matters that may influence taxpayers' behavioural responses converge around the higher rate thresholds for income tax. One is the comparison between the Scottish higher rate threshold at £43,430 with the higher rate threshold in the rest of the UK at £50,000. The other is the interaction between the income tax higher rate thresholds and the NIC upper threshold. Both these matters make SIT feel more expensive relative to other taxpayers in the UK – and may therefore have behavioural implications.

14. The higher rate income tax threshold which is set by Westminster and only applies to the rest of the UK indirectly challenges options in Scotland because there is a seemingly automatic reaction by the public to compare any devolved tax measure with that in the rest of the UK. The proposed higher rate threshold for Scottish taxpayers is lower than in the rest of the UK and, combined with the tax rates at the higher and top rates, Scottish taxpayers will pay more than their counterparts in the rest of the UK.

15. However, care needs to be taken in making comparisons. And these can be presented in a confusing manner that results in a lack of transparency and understanding. These comparisons can include:

- For 2019/20 comparing a Scottish income taxpayer and a 'rest of UK' income taxpayer – is a Scottish taxpayer better off than their neighbours?
- 2018/19 and 2019/20 – comparing a Scottish income taxpayer's circumstances from one year to the next – is a Scottish taxpayer better off from one year to the next?
- A comparison that looks at income tax only, or one that takes into account both income tax and NIC. For some, income tax and NIC are both payroll deductions and the important matter is the final take-home pay; for others, NIC is a social security contribution and nothing to do with tax. To complicate this, key elements of income tax (the rates and thresholds) are devolved but NIC is reserved.

16. Within comparisons between Scottish taxpayers and those in the rest of UK in 2019/20, the difference in tax payable will be largely due to the revised 5-band structure with the one percentage point extra that was added to the higher and top rates last year, and maintained in this budget, and the freezing of the higher rate threshold.

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[2] https://www.gov.scot/binaries/content/documents/govscot/publications/factsheet/2018/12/scottish-income-tax-2019-2020/documents/analytical-note-on-impacts-on-income-levels-and-equality/analytical-note-on-impacts-on-income-levels-and-equality/govscot%3Adocument see key findings

17. Within comparisons for Scottish taxpayers from one year to the next, reductions in income tax payable come from a mixture of UK-wide measures (mainly due to the personal allowance) and Scottish measures (the setting of rates and bands, notably the higher rate threshold).

18. The behavioural implications of perceived increases in taxes can be divided into four categories, namely:

    - Individuals who are already Scottish taxpayers and living in Scotland
    - Individuals living outside Scotland who may be considering moving to Scotland
    - Growing businesses already operating in Scotland, and
    - Growing businesses operating outside Scotland.

    These are discussed further below.

**National Insurance**

19. There are two related NIC matters, which need a joint Scottish/UK approach to bring transparency and to address them. First, is the increase in NIC for any UK taxpayer as a result of the UK budget on 29 October. The UK higher rate threshold for income tax has gone up to £50,000, and the UK NIC upper threshold mirrors this. However, whilst the UK basic rate band for 2019/20 has widened by £3,000, the employee's NIC 12% band, which applies across the whole of the UK including Scotland, has widened by £3,442. On earnings up to £50,000 less income tax is collected, whilst more NIC is payable.

20. Second, a further anomaly arises in Scotland due to the interaction (or lack of it) between the UK-wide NIC upper threshold of £50,000 and the devolved higher rate threshold for SIT. Scottish taxpayers with income between £43,430 and £50,000 will pay a combined marginal rate of 53% (41% SIT and 12% employee's NIC). This was already a concern in 2018/19, but this budget is widening the 53% band in 2019/20.

21. For a 'rest of UK' taxpayer in 2019/20 with an income of £50,000 their position compared with 2018/19 will be a net increase in their take home pay of £520. This is made up of reduced income tax of £860 but £340 more national insurance.

22. For a Scottish taxpayer in 2019/20 with an income of £50,000 their position compared with 2018/19 will be a net reduction in take home pay of £200 made up of reduced income tax of £140 but an extra amount payable of £340 NIC.

    See the numerical illustrations in the appendix.

**Scottish taxpayers**

23. With the gap between the higher rate thresholds widening between Scotland and the rest of the UK in 2019/20, there may be behavioural consequences. For example, if an individual is in a position to mitigate their tax bill by incorporating and taking remuneration up to the personal allowance, with the remainder by dividend, this would divert any tax payable away from Scotland altogether and into the UK exchequer as corporation tax on company profits and income tax on dividend income.

24. Any taxpayer who views a tax bill as an unwanted cost may seek to minimise this and so divergent rates across income tax (Scottish and UK), corporation tax and capital gains tax lend themselves to tax planning behaviours such as business incorporation by an individual who wishes to be paid in dividends rather than a salary.

25. We discussed this in our submission to the Committee's inquiry into a 'Scottish Approach to Taxation' – and increasing the amounts of Scottish income tax payable relative to the rest of the UK, along with the UK proposal to reduce corporation tax to 17% from April 2020 can only encourage this type of tax planning.

26. There may also be a less quantifiable move to minimise taxable income in the middle band where the 53% charge sits. Employers may decide to reconfigure remuneration packages to enable their employees to exchange salaries/wages for NIC-efficient items

such as pensions or holidays; or individuals may increase their pension contributions or reduce their workload and hence their taxable pay. All small measures, but nevertheless, measures which could add up across the piece.

**Will individuals wish to migrate to Scotland?**

27. There is also the issue of whether Scotland is now portrayed as 'expensive' and, alongside the tax equalisation packages put in place by the MoD[3], there is anecdotal evidence that higher rates may be a disincentive when employers seek to recruit from outside Scotland, particularly for higher-paid, professional staff. Given Scotland's excellent transport links, higher tax rates in Scotland may also encourage some higher-paid individuals to maintain their main home south of the border while working here.

**Businesses**

28. Growing businesses already operating in Scotland and growing businesses operating outside Scotland will, in each case, be considering whether their best strategic objective would be to expand their workforce inside or outside Scotland.

**Forecasts, data issues, and transparency**

29. There have clearly been issues around aspects of the forecasting of Scottish income tax, as discussed in the recent Scottish Parliament's Finance and Constitution Committee report 'Pre-budget scrutiny report'[4]. There seems to be a lack of sound data, as revealed by the differences between the forecast and actual numbers of higher and additional rate taxpayers in Scotland (paragraph 73).

**Table 5. Number of Income Taxpayers, 2016/17**

| | **Higher Rate** | **Additional Rate** |
|---|---|---|
| SFC May Forecast | 308,500 | 15,500 |
| HMRC Outturn Figure | 294,000 | 13,300 |

30. We would encourage the development of better data than is currently available. HMRC's identification of Scottish taxpayers is a basic example of an area where accurate and comprehensive information flow is essential to the Scottish Government. Clearly, the information flow should be barrier-free and mutually recognised as beneficial, to ensure that tax revenues on both sides can be optimised and any potential loopholes identified and resolved expeditiously.

**Land & Buildings Transaction Tax (LBTT)**

31. Changes are proposed to LBTT as follows from 25 January 2019:

- The rate of Additional Dwelling Supplement will change from 3% to 4%, and
- LBTT rates and thresholds for non-residential properties are to be amended such that an anticipated two-thirds of all non-residential transactions will result in less LBTT payable.

32. The Scottish Budget also announced the intention to introduce two reliefs from LBTT for property investment funds, which we welcome.

**Process**

33. LBTT has been notable in that since its commencement in April 2015 there have been several changes to it. These have included:

    - A new charge to tax – the Additional Dwelling Supplement
    - A new relief – first-time buyer relief, and
    - Removal of anomalies – for example around group relief.

[3] https://www.gov.uk/government/news/military-personnel-in-scotland-protected-from-tax-hikes

[4] published 7 November 2018 https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutiny-report-2/FCCS052018R12Rev.pdf

34. A key issue is that there is no regular process for bringing forward and considering such changes, and it would be helpful if there was. There is also a need for 'care and maintenance' measures in the existing tax law so that, if stakeholders such as Revenue Scotland find parts of the legislation do not work as intended or the legislation does not work as taxpayers require from a commercial perspective, there is an opportunity to revisit the law. To date, possible amendments to tax law have been raised on an ad hoc basis.

35. The increase in the charge to Additional Dwelling Supplement is likely to sharpen concerns amongst taxpayers about a number of perceived anomalies in the legislation, particularly where two people become a couple, where a couple split up, or where market conditions delay the sale of the old property on a simple house move.

36. An annual UK Budget is needed because income tax is an annual tax – it must be enacted every year. In Scotland there is no such requirement, other than for an annual Scottish rate resolution setting the income tax rates and bands. This limited annual tax procedure is not enough. To maintain and improve Scottish taxes a broader, regular, formal, parliamentary process is needed. It is encouraging to note that included in the Scottish Government's legislative programme for 2018/19 is a pledge to reform the way in which devolved tax decisions are planned, managed and implemented[5]. It is hoped this will be put in place as soon as possible.

37. It is highly desirable that any process to implement tax change will be enacted in primary legislation. To date, there has been a tendency to use secondary legislation in the form of Scottish Statutory Instruments instead of primary legislation, such as with the most recent LBTT Group Relief (No.222) and First Time Buyer relief (No.221) orders of 2018. ICAS does not believe that this is an appropriate way to exercise tax powers because it lacks both visibility and active parliamentary consideration. This should encourage full debate about likely repercussions of changes, such as administrative costs to businesses of updating systems – a factor often under-estimated.

[5] https://www.gov.scot/publications/delivering-today-investing-tomorrow-governments-programme-scotland-2018-19/ page 61

**Appendix 1**

**Combined income tax and NIC liabilities**
**Rest of UK tax payers 2019/20 v 2018/19**
**Scottish taxpayers 2019/20 v 2018/19**

**Tax computation for a rest-of-UK taxpayer, 2019/20 and 2018/19 – earnings of £50,000**

| Tax Computation | 2019/20 £ | 2019/20 £ | 2018/19 £ | 2018/19 £ |
|---|---|---|---|---|
| Earnings: | 50,000 | | 50,000 | |
| Less: PA | (12,500) | | (11,850) | |
| Taxable earnings | 37,500 | | 38,150 | |
| Income Tax @ 20% on: | 37,500 | | 34,500 | |
| Income Tax due: | | 7,500 | | 6,900 |
| Income Tax due @ 40% on: | n/a | | 3,650 | |
| Income Tax due: | n/a | nil | | 1,460 |
| Total income tax due | | 7,500 | | 8,360 |
| Employee NICs @ 12% on: | 41,368 | | 37,926 | |
| Employee NICs due: | | 4,964 | | 4,551 |
| Employee NICs due @ 2% on: | n/a | | 3,650 | |
| Employee NICs due: | | Nil | | 73 |
| Total Employee NICs due | | 4,964 | | 4,624 |
| Total Income Tax and NICs due: | | 12,464 | | 12,984 |

In 2019/20 in the rest of the UK, compared with 2018/19, the taxpayer's total income tax and NICs liability **reduces** by £520, although the income tax payable reduces by £860. While the overall liability reduces, the NICs payable on the same income actually **increases** by £340.

**Tax computation for a Scottish taxpayer, 2019/20 and 2018/19 – earnings of £50,000**

If the taxpayer was a Scottish taxpayer for 2018/19, earning the same salary, they would pay £824 more than in the 'rest of the UK'.

For 2019/20, due to the holding down of the higher rate band, they will pay £1,544 more, as the following table shows:

| Tax Computation | 2019/20 £ | 2019/20 £ | 2018/19 £ | 2018/19 £ |
|---|---|---|---|---|
| Earnings | 50,000 | | 50,000 | |
| Less: PA | (12,500) | | (11,850) | |
| Taxable earnings | 37,500 | | 38,150 | |
| SIT @ starter rate 19% on | 2,049 | | 2,000 | |
| SIT due: | | 389 | | 380 |
| SIT @ basic rate 20% on | 10,395 | | 10,150 | |
| SIT due: | | 2,079 | | 2,030 |
| SIT @ intermediate rate 21% on | 18,486 | | 19,430 | |
| SIT due: | | 3,882 | | 4,080 |
| SIT @ higher rate 41% on | 6,570 | | 6,570 | |
| SIT due: | | 2,694 | | 2,694 |
| Total SIT due | | 9,044 | | 9,184 |

| | | | | |
|---|---|---|---|---|
| Employee NICs @ 12% on: | 41,367 | | 37,925 | |
| Employee NICs @ 12% | | 4,964 | | 4,551 |
| Employee NICs @ 2% on: | n/a | | 3,650 | |
| Employee NICs @ 2% on n/a | | Nil | | 73 |
| Total Employee NICs due | | 4,964 | | 4,624 |
| Total Income Tax and NICs due | | 14,008 | | 13,808 |

Due to the divergence in Scottish income tax rates and bands from the rest of the UK, the Scottish taxpayer's increased total tax bill is mostly due to the higher income tax payable at this level of earnings.

However, both Scottish and UK taxpayers will each face an increased NICs charge of £340 on these earnings in comparison to 2018/19.

Scottish taxpayers in the income bracket of £43,430 - £50,000 also face a combined marginal rate of 53% on this income.