Scottish rate of income tax

From 6 April 2016, different rates of income tax may apply in Scotland.

Under Scotland Act 2012, UK income tax rates will not apply to Scotland. Instead, the UK element of income tax will be ten percentage points lower than for the rest of the UK. The Scottish Parliament will then set its element of income tax rates which may equal ten percentage points, or may be a greater or lesser amount. This added element is known as the **Scottish rate.** This Scottish rate will go directly to the Scottish government. There will therefore be a corresponding change in funding from the UK government.

This differs from the existing power given to the Scottish Parliament which permits it to vary the UK basic rate of income tax by just three percentage points either way. This power was given under Scotland Act 1998 that re-created the Scottish Parliament. The power was never used. The new power increases the variance to ten percentage points, and extends it to all rates of income tax, and not just the basic rate.

If the Scottish Parliament decided to add just nine percentage points, the Scottish rates would be 19%, 39% and 44% as against 20%, 40% and 45% for the rest of the UK. If it decided to add eleven percentage points, the Scottish rates would be 21%, 41% and 46%. If the Scottish Parliament decided to add ten percentage points, the Scottish rates would be the same as for the UK.

The three new rates that may be created in Scotland have imaginatively been christened Scottish basic rate, Scottish higher rate and Scottish additional rate.

The Scottish Parliament may only set one Scottish rate, so it could not, for example, reduce the basic rate by 9 points and increase the higher rates by 12 points.

The amounts of personal allowance will remain the same for Scottish taxpayers as for other UK taxpayers. All other rules of income tax remain the same.

Scotland will also get new powers to charge its own landfill tax and stamp duty land tax. It has not been given the power it has pressed for to set its own rate of corporation tax.

Guidance notes have been issued on some of the practical issues.

Savings income will be charged at the UK rate. There are also some other provisions where the UK rates will continue to apply in Scotland.

Who is a Scottish resident?

The Scottish rate is charged on the non-savings income of Scottish residents.
A Scottish taxpayer must first be a UK resident. A non-resident can never be a Scottish taxpayer. If someone has earnings subject to UK income tax, it will be at the UK rates.

Every member of the Scottish Parliament, every MP who represents a Scottish constituency and every MEP who represents Scotland is automatically taxed as a Scottish taxpayer, regardless of where they live.

Subject to the rule for politicians, a Scottish person not living in Scotland will not pay the Scottish rates. Liability is determined by residence and not nationality.

Having established UK residence, the next determinant is whether the taxpayer's sole or main residence is in Scotland. If it is, they are a Scottish taxpayer.

For taxpayers who have residences in both Scottish and in another part of the UK (such as England), residence is determined by which residence is occupied for longer. Note that this is not a matter of choice as applies for main residence relief for capital gains tax. Residence here is a matter of fact.

Where a taxpayer cannot identify a main residence, the taxpayer must count the number of days spent in Scotland. If they spend more days in Scotland than elsewhere in the UK, they are Scottish resident.

It seems that it is not necessary for someone to be in Scotland for 183 days a year. Someone who travels overseas and spends only 40 days in Scotland and 35 days in England could be regarded as Scottish resident.

Someone is either Scottish resident or non-Scottish resident for a whole tax year. A person cannot be regarded as Scottish resident for part of a tax year. Scottish residence can change from one tax year to the next.

PAYE

All payrolls must operate the Scottish rates of income tax for Scottish residents, regardless of where the employer is based. This means that an English business could have to apply Scottish rates to a representative who lives in Scotland, for example.

All PAYE codes for Scottish residents will be prefixed with the letter S, in the form S187L. For such employees, the payroll department must use Scottish rates. Payroll software should be amended by 2016 to deal with this automatically.

Partnerships

There is no change to tax law for partnerships. The fact that a partnership is a legal entity in Scotland but not in England is irrelevant.

Under existing tax law, a partnership itself is not taxed. Instead the partners are taxed on their share of the partnership income.

This will continue to be the case. The difference is that any Scottish resident partner may pay income tax at a different rate from his or her English partners.

Charitable giving

Where a taxpayer donates £80 to a charity under Gift Aid, the charity may claim back £20 from HMRC. This is equal to the basic rate of 20% of the £100 the taxpayer earned to be able to make the donation of £80. If the taxpayer is liable to the higher or additional rate of income tax, the additional tax is refunded to the taxpayer.

It has been decided that the UK rates will continue for charitable giving by Scottish residents under Gift Aid.

It is recognised that this means that charities may be overclaiming or underclaiming tax relief if the Scottish rate is different. However to reflect this change would mean that every charity would have to operate two systems of Gift Aid, establish which donors were Scottish resident and claim different rates of tax relief.

It was concluded that this would be an unreasonable administrative burden on charities to deal with differences that were unlikely to be significant.

The government has said that it will keep the matter under review. If there is a significant divergence between UK and Scottish rates, different provisions may be introduced.

There is a change for Scottish taxpayers who pay the **higher or additional rates** of tax. The amount of tax relief provided to them will be the difference between the Scottish basic rate and either the Scottish higher rate or additional rate.

Suppose the Scottish rates are 1 percentage point above UK rates. The value of a £100 donation under the Scottish basic rate of 21% is £126.58. A Scottish taxpayer liable for Scottish higher rate of 41% would claim the 20% difference between the rates on the grossed-up income of £126.58. This equals £25.32.

An English taxpayer doing the same would receive just £25. This provision is illogical as tax relief would have been given on the UK basic rate of 20%, so in the example above, a more accurate figure would have been 21% of £126.58, which is £26.58. Also, the difference is only 32p per £100, which hardly justifies a different tax system.

Tax relief can also be provided at source under **payroll giving.** This operates by subtracting the charitable donation from gross pay before calculating tax. This will not change.

This means that someone donating £100 under payroll giving would (continuing with our example) get 21% tax relief at source, so the net cost to the employee is £79.

It is also possible for individuals to get tax relief for **shares or land** donated to a charity. This is indicated on the self-assessment tax return. This again will not change. It means that tax relief will again be given at the Scottish rates.

Pension contributions

Contributions to pension funds are tax-deductible up to certain limits, including the annual limit now set at £50,000 a year.

There is no particular problem for **occupational pension schemes**. Tax relief is given at source. That can be given at the Scottish rates as easily as for the UK rates.

Some taxpayers may still be making contributions to a **retirement annuity contract.** This was a predecessor to the personal pension. Tax relief for these contracts is given from the self-assessment return, so again there is no great problem in granting relief at the Scottish rates.

For other forms of **approved pension**, the contribution is regarded as being net of basic rate tax. A sum equal to the tax is then paid into the pension fund by HMRC.

The issue of what to do about income tax relief for such contributions has yet to be resolved. It is a balance between providing the correct amount of tax relief and not imposing undue administrative burders on pension fund providers.

Discussions will be held with the pension industry on this matter. The initial plan is that tax relief will be refunded based on UK rates, provided that there is no great divergence between UK and Scottish rates.

There are some **special tax rates** for pensions. These apply when a refund is given other than as a lump sum or pension payment. The higher rates are designed to recoup the tax relief already provided when the contributions were made. It is intended that these special rates will remain the same in Scotland. They are only an approximation, which is likely to hold good provided that Scottish and UK rates do not diverge by much.

Trusts and estates

Trusts and estates are subject to income tax. There are already rules to establish whether a trust is UK-resident, and different rules to establish if an estate is UK-resident.

The government has concluded that this area of law is already too complicated, and does not want to add further complexity by regarding trusts and estates as Scottish resident and therefore subject to a different rate of income tax.

Accordingly, it is intended that all trusts and estates will pay income tax at UK rates even if they would otherwise be regarded as Scottish-resident.

Trust income arising to or received by an individual Scottish resident would be subject to the Scottish rates.

For a **bare trust,** the tax would be charged according to whether the beneficiary is Scottish-resident. A bare trust is similar to a power of attorney, so this is the obvious solution.

For **discretionary trusts,** special rates of tax apply. From 2013/14, these are 45% except for dividends where it is 37.5%. These rates are unchanged for Scottish discretionary trusts. When the beneficiary receives a payment, it comes with a tax credit equal to the tax paid at these special rates. A Scottish-resident beneficiary will get a tax credit for the tax deducted at these special rates. This will gross up the payment. The Scottish rates will then be applied to the grossed up receipt.

Under an **interest in possession trust,** the beneficiary has a legal right to receive the income as it arises. This is an area where Scots law differs from English law. Under Scots law, the beneficiaries do not have the legal right to income as it arises but have other rights against the trustees to ensure that the trust purposes are being followed. Current tax law is the same for such trusts whether in Scotland or England, regardless of the difference in legal rights.

Personal representatives dealing with the **estate** of a deceased person will also pay income tax at UK rates. When paying funds to the beneficiary, this will have tax deducted at the UK rate. This will again be grossed up and Scottish tax deducted on the grossed-up figure.

Where the income is savings income on which UK basic rate has been deducted and the Scottish beneficiary is a basic rate taxpayer, no further tax is payable or refundable. In other cases, the income is disclosed on a self-assessment tax return.

Other forms of non-savings income, such as rent from property, earned by an interest in possession trust or by an estate will be excluded from the Scottish rates and subject to the UK rates.

Some **foreign trusts** give the beneficiary a right to receive income as it arises. As such income will not have borne any UK tax, the beneficiary is taxed on the income received. For a Scottish beneficiary, this will be at the Scottish rates.

A **settlor interested trust** is one where the settlor, who creats the trust, is entitled to benefit from it, or where members of his family may benefit. The trust will account for tax using UK tax rates. This creats a tax credit in the hands of the beneficiary. If that beneficiary is Scottish resident, they will pay tax at the Scottish rates on the grossed up receipt.

Foreign entertainers and sportsmen

Foreign entertainers and sportsmen earning money by performing or competing in the UK are generally subject to a withholding tax equal to the basic rate of income tax.

As such people are not UK-resident, they cannot be regarded as Scottish-resident. Therefore the withholding tax rate will remain the same as the basic rate of income tax.

Non-resident landlord scheme

Under this scheme, rent paid by UK tenants to non-resident landlords have basic rate tax deducted.

This will continue to be at the UK rate when paid by Scottish tenants.

Non-doms

The government has introduced an annual charge of £30,000 a year for non-domiciled people who live in the UK. A higher charge for long-term non-doms has been announced.

This figure remains unchanged regardless of whether the non-dom lives in Scotland.

Construction Industry Scheme

Under this scheme, a contractor must deduct an amount of tax from payments to non-registered subcontractors. The rate is 20% for registered subcontractors and 30% for those not registered.

These deductions are payments on account of the subcontractor’s eventual liability for income tax and class 4 national insurance. Unlike PAYE, it does not attempt to collect the correct amount.

As the rate is an approximation and a payment of account, these rates will continue to apply in Scotland. A Scottish subcontractor will be liable to pay the Scottish rates from which the CIS deductions may be subtracted.

PAYE settlement agreements

PAYE settlement agreements (PSAs) are arranged between HMRC and an employer whereby the latter makes a payment in respect of employees’ tax liability when it would be difficult to assess the employee directly. The amounts are often small. The employer is required to make an assessment of the rates of tax the employees would have paid. Class 1B national insurance is paid on the amount of the PSA.

The calculation should consider how much is subject to Scottish rates of income tax. This may make the calculation a little more complicated, but not to do so would further compromise the integrity of what is already an approximation of the tax due.

Award schemes

There are schemes separate from PSAs whereby the employer may agree to pay the employee's income tax on a grossed up figure. The commonest example is a prize for achievement in the workplace, where the employer does not want the impact blunted by the employee having an increased tax liability.

As these schemes are specific to individual employees, the amount must be calculated for each employee using their marginal rate of tax. For a Scottish resident, the Scottish rate must be used.

Life assurance

There is a special policyholder rate of corporation tax that applies to life assurance companies and friendly societies. It is set at the same rate as the basic rate of income tax.

As the Scottish rates only apply to individuals, this rate will remain at the UK basic rate.

REITs

Real Estate Investment Trusts (REITs) are a form of collective investment scheme in property.

REITs are exempt from tax on their property rental. This becomes taxable when distributed to the unit holders, when an amount equivalent to the basic rate income tax must be deducted.

They will continue to use the UK rate for such deductions, even when the unit holder is Scottish resident. This is to avoid administrative work for REITs.

Authorised investment funds

Authorised investment funds (AIFs) are collective investments. The AIF is itself subject to corporation tax. Payments made by the AIFs are taxed in the same way as a dividend from a company. As dividends remain subject to income tax at the UK rate, there are no implications for the Scottish rates.

Withholding taxes

There are several situations where a person is required to withhold tax equal to the basic rate of income tax.

Many of these will take the form of savings income which remains subject to UK rates of income tax.

A few exist which do not relate to savings. These include annual payments and certain payments from non-pension annuities.

All such payments will remain subject to the UK rates and not the Scottish rates.

Double taxation treaties

The Scottish rate is a local variation of UK income tax.

It is not a discrete tax. Therefore it is covered by all existing UK double tax treaties, of which there are more than 100. For countries with whom the UK has no such treaty, unilateral double taxation relief will continue to be available.

Setting off reliefs

A Scottish resident can find himself with non-savings income subject to two different rates of tax.

There are certain reliefs that may be offset against taxable income. Loss relief is a common example. There are some rules on how such reliefs may be offset. However, they still provide a degree of flexibility, allowing a taxpayer to choose the alternative that results in the greatest reduction of tax.

These principles will remain unchanged. With a Scottish rate, the taxpayer could have more choice. He may, for example, choose to claim a relief against income subject to a 21% Scottish rate rather than a 20% UK rate.