Advisor briefing on Draft Budget 2016-17: tax issues

1. The Draft Budget for 2016-17 was published by the Scottish Government (SG) on 16 December 2015. In 2016-17 the SG will receive income from three taxes, Land and Buildings Transactions Tax (LBTT), Scottish Landfill Tax (SLfT) and the Scottish Rate of Income Tax (SRIT). LBTT and SLfT are fully devolved taxes administered and collected by Revenue Scotland (RS) and have been in place since 1 April 2015. SRIT, to be introduced from 6 April 2016, gives the Scottish Parliament the power to set a single Scottish Rate of Income Tax in substitution for 10% of the three UK rates applied to non-savings, non-dividend income (NSNDI) of Scottish Taxpayers. HM Revenue and Customs (HMRC) will administer and collect SRIT. Apart from the rate setting power in SRIT, income tax remains a reserved matter and the NSNDI tax collected on the income of Scottish Taxpayers at each of the three UK rates, each reduced by 10%, goes to the UK Treasury.

SRIT

2. The SG proposes that SRIT be set at 10% for 2016-17. This has the net effect that Scottish Taxpayers will pay the same amount of tax on NSNDI as other UK taxpayers. The SG give two reasons for setting this rate. Given that the rate is applied to all three bands, any increase in rate would inappropriately increase the tax paid by lower income groups. As this will be the first year in which Scottish Taxpayers must be separately identified and a proportion of their tax on NSNDI paid to the SG, it is sensible to let the system "bed in" before varying rates. The impact of this decision is illustrated in the following table:

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1 Scotland's Spending Plans and Draft Budget 2016-17, p 15
The tax collected by HMRC by applying the rates in column 2 to the NSNDI of Scottish Taxpayers goes to HM Treasury and the tax collected by applying the rate in column 3 goes, in theory, to the SG. However, in 2016-17 transitional provisions apply.

3. The Command Paper, Strengthening Scotland's Future, set out the methodology for remitting SRIT to the SG. As income tax is collected in irregular amounts through the year and indeed to a significant extent during the following tax year, Treasury will pay the SG amounts as required based on the Office of Budget Responsibility (OBR) forecast of SRIT for the year. After the transitional period, the intention is for a reconciliation to take place when "nearly all" the receipts are known, and no later than 12 months after the end of the financial year, with an adjusting transfer to or from the SG. This reconciliation will not apply during the transition period and, consequently, for 2016-17 the SG will receive the OBR forecast amount of SRIT without any subsequent adjustment.3

4. The latest OBR forecast of the 10% SRIT yield for 2016-17 is £4,900 million. This is the amount the SG will receive and is also the amount by which the Block Grant will be reduced as a result of the devolution of this

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2 While income tax collected under PAYE is collected monthly, income tax under self assessment falls due on three dates, first installment 31 January in the tax year, second installment 31 July and balancing payment 1 January both in the following tax year. Seasonal and other changes in employment and overtime, annual and other bonuses will all result in variation of the amounts collected under PAYE month by month. Late or revised returns and concluded investigations may lead to tax being collected years later than the year for which it is due.


4 http://budgetresponsibility.org.uk/pubs/Devolved-taxes-forecast.pdf, Economic and fiscal outlook: Devolved taxes forecast, OBR, November 2015, Table 1.1, p 4
proportion of tax on the NSNDI of Scottish Taxpayers. There is, as a result, no risk to the Scottish Budget for 2016-17 from the introduction of SRIT and the consequent Block Grant adjustment.

5. From 2017-18 it is likely that SRIT will be replaced by the enhanced powers in the Scotland Bill 2015. Under these, the Scottish Parliament will have power to set the rates and bands for tax on NSNDI of Scottish Taxpayers independently of those in the rest of the UK and the full amount of such tax will be due to the SG. HMRC will continue to administer and collect the tax and similar arrangements to those for SRIT will apply to the remittance of Scottish Income Tax.

6. In future years when the amount ultimately received by the SG depends on the actual Scottish Income Tax for the year collected and recorded by HMRC, there will be a number of risks to be guarded against. These include a failure by HMRC to identify and collect tax from all Scottish Taxpayers, unanticipated behavioural effects arising from changes to the rates and bands of Scottish Income Tax or indeed UK Income Tax, unanticipated economic shocks or trends, forecasting weaknesses leading to over- or under-spending and unanticipated changes to the tax base or personal allowance by the UK Government. Alongside these, is the risk that the agreed methodology for the continuing Block Grant adjustment leads in the future to a reduction in Block Grant that is greater than can be offset by a growing Scottish NSNDI tax base. The methodology for future Block Grant adjustments forms part of the current Fiscal Framework negotiations.

**LBTT**

7. Amongst those responding to the Committee’s request for evidence on LBTT\(^5\), a number suggested that the housing market would benefit from a more stepped approach to rates above the £325,000 price threshold where the current rate jumps from 5% to 10% and for a raising of the threshold for

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\(^5\) [http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/91810.aspx](http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/91810.aspx)
12% from £750,000 to £1 million or even abolition of the 12% rate altogether. There was less concern over the impact of non-residential LBTT rates on the market although the Scottish Property Federation did suggest aligning the top rate of LBTT with the 4% top rate of SDLT to avoid any disadvantage for Scotland in the fiercely competitive commercial property market.

8. The SG has decided to make no change to LBTT rates for 2016-17 which remain as follows:

<table>
<thead>
<tr>
<th>Residential transactions</th>
<th>Non-residential transactions</th>
<th>Non-residential leases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rate</strong></td>
<td><strong>Rate</strong></td>
<td><strong>Rate</strong></td>
</tr>
<tr>
<td>Up to £145,000</td>
<td>nil</td>
<td>Up to £150,000</td>
</tr>
<tr>
<td>£145,001 to £250,000</td>
<td>2.0%</td>
<td>£150,001 to £350,000</td>
</tr>
<tr>
<td>£250,001 to £325,000</td>
<td>5.0%</td>
<td>Over £350,000</td>
</tr>
<tr>
<td>£325,001 to £750,000</td>
<td>10.0%</td>
<td></td>
</tr>
<tr>
<td>Over £750,000</td>
<td>12.0%</td>
<td></td>
</tr>
</tbody>
</table>

The SG consider that the residential rates appropriately redistribute the tax burden from lower to higher value transactions in comparison to SDLT and that the non-residential rates ensure that Scotland remains a competitive and attractive location for business. However, following the announcement by the Chancellor on 25 November 2015 of a supplementary SDLT charge of 3% on the purchase of additional residential properties, such as second homes and let properties, the SG similarly proposes a supplementary LBTT charge on such properties. For all transactions above £40,000 the supplementary LBTT charge will be 3% on the full value of the transaction.

9. While the SG make no reference to the proposed SDLT supplementary charge in the Draft Budget, one reason for introducing the LBTT charge must surely be that without it Scotland would become an attractive location for buyers of additional residential properties from the rest of the UK. This additional demand could have made home buying for locals more difficult and expensive particularly in the case of urban flats and in rural and recreational areas.

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6 [http://www.scottish.parliament.uk/S4_FinanceCommittee/General/Documents/Adviser_briefing_on_LBTT_Written_Evidence.pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/General/Documents/Adviser_briefing_on_LBTT_Written_Evidence.pdf), Adviser Briefing, paras 19 to 21
7 Ibid., para 22
8 Scotland’s Spending Plans and Draft Budget 2016-17, p 16
10 Scotland’s Spending Plans and Draft Budget 2016-17, p 17
areas. The reason given for introducing it is to support home ownership in a balanced and sustainable way and to help ensure that the tax charge is proportionate to the ability to pay. The application of the 3% to properties between £40,000 and £145,000, which otherwise are exempt from LBTT is justified as targeting a market where demand for second homes or investment properties could make it difficult for new entrants to the market to purchase a main residence.  

10. The Committee has raised a number of questions about the proposed LBTT supplement in its Call for Evidence on the subject. The definition of additional residential property will require careful definition. Scenarios that require consideration are:

a. When purchasing a new home, the old home proves difficult to sell. Will there be a time limit on how long the old house can continue to be owned before the new one is reclassified as an additional residential property? Will it make a difference if mortgage costs force the owner to find a tenant meantime for the old property?

b. The matrimonial home is in the name of the husband. If the wife buys a letting property is it an additional residential property? If they are co-habitants rather than married, does that make a difference?

c. Parents buy a flat for student children to live in. Is it an additional residential property? Does it make a difference if the children have friends who pay to share the flat?

d. Similarly, is the purchase of a nearby property for an elderly or infirm dependent additional residential property?

e. An overseas resident, or resident in the rest of the UK, buys a property in Scotland with a view to retiring here at a future date, letting it or using it as a holiday home meantime. Is it an additional residential property and does it make a difference?

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Scotland's Spending Plans and Draft Budget 2016-17, p 18
whether the current residence outside Scotland is owned or rented?

f. An individual buys a property as his or her residence but unforeseen circumstances require them to work elsewhere for a period where they live in lodgings, meanwhile letting the purchased residence to a colleague. Is it an additional residential property?

11. Capital Gains Tax (CGT) gives a tax exemption on disposal of a principle private residence but not on disposal of second homes and let property and so CGT rules may be some help in designing the LBTT legislation. However, LBTT applies on purchase and not disposal and so will not have the benefit of hindsight regarding the use of the property.

12. One particular area of interest must be the application, or not, of the supplement where residential properties are purchased by companies. With the impending restrictions on the deductibility of interest costs for income tax in property letting businesses, there are already articles in the professional press exploring the future tax savings from owning letting property through a company. If the LBTT supplement (and SDLT supplement) do not apply to companies this developing trend will be accelerated with loss for the SG of, not just of LBTT supplement, but also income tax on NSND. If LBTT supplement is to apply to companies, the concept of "additional residential property" will not be straightforward. A husband and wife company buying a letting property or a family company buying a holiday property are obvious cases where the supplement should, in fairness, apply but companies, whether with widely spread shareholdings or not, which are letting substantial numbers of student flats or retirement flats would not seem appropriate subjects for the supplement. And there will be many cases that fall in between these two ends of the spectrum, so defining which companies will be subject to the charge and which not will be difficult.

13. Another potential way of avoiding the residential supplement would be for aspiring landlords to acquire a property as their only residence, "do it up", 
then let it and purchase a new property as their own residence, perhaps repeating the process multiple times. While devising rules that will charge LBTT supplement on the subsequent purchases of sole residences, or retrospectively on the previous residences when they are let, may not be too difficult there will be the further complication of those who buy a residential property with no intention of letting but find that work requires them to move away and an immediate sale is not practicable for one reason or another.

14. The introduction of the LBTT supplement is justified as a protection for the homebuyer who may otherwise be squeezed out of the market. This needs to be balanced against the need for sufficient rental accommodation for those who do not qualify for a mortgage or whose work or other circumstances require shorter-term residence in a series of locations making property purchase impractical.

15. The forecast tax revenue from LBTT for 2016-17 is £538m with £295m from residential property, £23m from the residential transaction supplement and £220m from non-residential transactions. In the narrative, the estimate for the yet-to-be-legislated supplement is given as £17m to £29m with the forecast of £23m being the median value. The November 2015 OBR forecast for LBTT in 2016-17 is £496m and was made before the announcement of the supplementary charge. Hence the comparative SG forecast is £515m which is 3.8% higher than the OBR.

16. The Scottish Fiscal Commission (SFC) in their Report on the Draft Budget 2016-17\(^\text{12}\) review the SG forecasts for LBTT in detail in Chapters 3 and 7, commenting on weaknesses in the methodology applied and recommending methodology, approaches and data gathering that should be considered for the future. The 7 months of available outturn for 2015-16 residential LBTT confirms that behavioural responses to tax changes can have a significant impact. In particular the SFC express concern that the introduction of residential supplement for 2016-17 may impact on the market.

\(^{12}\) [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)
in ways not taken account of in the SG forecasts. They do believe the forecast of LBTT revenues for 2016-17 to be reasonable, however.

**SLfT**

17. The SG proposes to increase the rates of SLfT in line with inflation and to match the UK Landfill Tax Rates for 2016-17. Matching the UK Rates is seen as important to avoid "waste tourism", the shipping of waste cross border to qualify for a cheaper tax rate. The SG considers these rates will continue to provide financial incentives to support delivery of ambitious waste targets including reducing waste to landfill to no more than 5% by 2025. There is no change to the credit rate for the Scottish Landfill Communities Fund which is maintained at 5.6%, exceeding the planned UK credit rate of 4.2% and enabling a relatively greater contribution to community and environmental projects. The proposed rates for 2016-17 are:

<table>
<thead>
<tr>
<th>Standard rate</th>
<th>£84.40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower rate</td>
<td>£2.65</td>
</tr>
</tbody>
</table>

18. The forecast revenue for 2016-17 from SLfT is £133m. The SFC in section 4 of their report express some concern that the forecast is based on the assumption that linear progress is being made towards the 2025 target of 5%. However, following enquiry, they are broadly satisfied that policies are in place which could feasibly deliver this target. Going forward, it will be necessary to monitor that "linear" progress is achieved, as underachievement in an earlier year will result in the forecasting model assuming more rapid progress in subsequent years. The outturn data for 2015-16 are being used to refine the forecasts as some of the UK based assumptions used in the 2015-16 assessment appear not to hold for Scotland. However, as only two quarters' results are currently available there is a vulnerability to possible seasonal fluctuations in assuming the same pattern for the full year 2016-17.

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13 Scotland's Spending Plans and Draft Budget 2016-17, p 18
14 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)
Overall, they believe the SLfT forecast reasonable.

Gavin McEwen
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