Introduction

The Law Society of Scotland aims to lead and support a successful and respected Scottish legal profession. Not only do we act in the interests of our solicitor members but we also have a clear responsibility to work in the public interest. That is why we actively engage and seek to assist in the legislative and public policy decision making processes.

These comments have been prepared on behalf of the Society by members of our Tax Law committee (‘the committee’). The committee welcomes the opportunity to respond to the Scottish Parliament’s Inquiry into the Devolution of Further Fiscal Powers and has the following comments to make. Our comments are restricted to consideration of the further devolution of taxes. The limited consultation period does not allow for a comprehensive review of the implications of further tax devolution. Consequently, our comments generally focus on assessing the framework of further devolution rather than specifics. These comments should not be interpreted as implying that the committee believes a particular tax should or should not be devolved. They are restricted to our assessment of the technical implications in the event a particular tax is devolved.

Q. 1 What general principles should apply to the devolution of further financial powers to the Scottish parliament?

Existing deficiencies in the UK tax system should not be replicated in Scotland. The devolution of further financial powers would provide Scotland with an opportunity to create a new tax model. The UK’s tax system is amongst the most complex in the world. If the intention is simply to “kilt” the existing model then further devolution will add a further layer of complication to an already complex system to the detriment of Scottish tax payers. In the event of substantial tax devolution (similar to that proposed by the Scottish Government) we would recommend that a root and branch approach to the existing tax system is taken. We accept that there is not the same opportunity to do this with more limited devolution.

Further devolution would obviously result in greater fiscal autonomy for the Scottish Parliament. A consequence would be the responsibility of generating sufficient revenue to fulfil the targets and outcomes in the National Performance Framework. The opportunity of determining tax reliefs available may also help facilitate this. For example, in the hypothetical situation where Capital Gains Tax was fully devolved then the Scottish Parliament could determine that CGT reliefs would be available, for example, to encourage the regeneration of historic buildings. In this sense, further tax devolution would have the advantage of increased local accountability.
The Scotland Act 2012 (“2012 Act”) inserts new sections 80D-80F into the Scotland Act 1998. Section 80D defines who will be a Scottish taxpayer for the purposes of the Scottish rate. Therefore what constitutes a Scottish taxpayer has already been established in legislation (at least for individual tax payers). However, it is important that mechanisms are put in to be able to quickly identify when a person becomes, or ceases to be, a Scottish taxpayer. Whether a person is or is not a Scottish taxpayer should be reviewed on an annual basis.

Generally, it is important that the tax systems in both Scotland and the rest of the UK (“rUK”) remain competitive in the event of further devolution. We would suggest that consideration is given to the recommendations made by the Office of Tax Simplification in their report on improving the competitiveness of the UK tax administration. More devolution also increases the prospect of cross-border complications arising including the issue of tax competition between Scotland and the rUK. It would be undesirable if tax rates were so different so as to given one part of the UK a competitive advantage over the other. Similarly, it would not be desirable for the system to lead to “border runs” where individuals look to take advantage of more lucrative tax opportunities on the other side of the border.

Greater tax avoidance opportunities will arise as the tax system in Scotland and the rUK becomes more distinct. A concentrated commitment by HMRC and Revenue Scotland will be essential to minimise this risk.

Q.2 What further financial powers should be devolved to the Scottish Parliament and why?

The following should not be interpreted as implying that we believe certain financial power should be devolved. Rather, our comments are restricted to our assessment of the financial powers that we think would cause least technical difficulties if they were to be devolved.

**Income Tax**

The 2012 Act introduced the Scottish Rate of Income Tax (“SRIT”). This will be charged on the non-savings income of Scottish taxpayers from April 2016. The income tax rate paid by Scottish taxpayers will be calculated by reducing the basic, higher and additional rates by 10 pence in the pound and adding the SRIT set by the Scottish Parliament. The consequence of having only one SRIT is that the basic, higher and additional tax rates can only be altered in a uniform manner (e.g. if the SRIT was 9% then the basic, higher and

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additional rates would all be 1% lower. If the SRIT was 11% then the basic, higher and additional rates would all be 1% higher).

There seems to be general consensus amongst the main political parties that the rates should be able to be altered independently of each other. Whilst this change would add some further complication to the changes introduced in the 2012 Act they would be relatively minor and we see no technical difficulties in enacting such a change.

Generally, we do not perceive any technical difficulties in devolving the power to set the Income Tax personal allowances to the Scottish Parliament. However, the impact of different income tax rates on gift aid (for example the situation where an rUK tax payer wants to become a member of the National Trust for Scotland) is a matter that requires to be further addressed.

We anticipate technical difficulties if the taxation of savings income was to be devolved. This is addressed further at question 3 below.

**National Insurance Contributions ("NIC")**

NIC is inherently linked to income which is liable to Income Tax. In the event that Income Tax was fully devolved then this would create the opportunity to amalgamate at least employees' NIC and Income Tax, a proposal already discussed between HMRC and professional bodies. However, as NIC is still hypothetically linked to the qualification for certain benefits including the State Pension, there may be unintended consequences of devolving any element of NIC, depending on the future treatment of benefit and pension entitlements.

**Air Passenger Duty ("APD")**

The devolution of APD was recommended by the Calman Commission. APD is already substantially devolved to the North Irish Assembly. We do not anticipate that devolving APD would result in technical difficulties or significant administrative or economic inefficiencies. Devolution of APD would provide an additional fiscal lever for the Scottish Parliament.

**Annual Tax on Enveloped Dwellings ("ATED")**

ATED is payable by companies and other non-natural persons owning high value residential property. It was introduced in 2013 as part of a three pronged attack on the perceived avoidance of Stamp Duty Land Tax ("SDLT") through “enveloping”, the acquisition of residential properties through companies. The other elements are a 15% SDLT charge on the acquisition of residential property by companies and a 28% CGT on the disposal of properties subject to ATED.
SDLT has been devolved to the Scottish Parliament from 1 April 2015 and will be replaced by Land and Buildings Transaction Tax ("LBTT") which will be collected by Revenue Scotland. The Scottish Government has decided to take a different approach to the perceived issue of “enveloping”. The LBTT legislation and the LBTT rates which have recently been announced do not include an equivalent to the 15% SDLT charge. Instead the Land and Buildings Transaction Tax (Scotland) Act 2013 envisages an LBTT charge on the transfer of shares in companies holding residential property.

As things stand, however, ATED applies to properties in Scotland as well as in the rest of the UK since ATED is not switched off by the Scotland Act 2012 as it is not part of SDLT, but is a different tax. Given the devolution of SDLT to the Scottish Parliament from 2015, it is not appropriate for ATED to apply to properties in Scotland after that date. Although ATED currently only applies to properties with a value of £2m, and therefore may not have been perceived as a problem in Scotland when it was first introduced in 2013, from April 2015 the threshold is reduced to £1m, and from April 2016 to only £500,000 so it will apply in many more cases. We recommend that amendments should be made to the ATED legislation so that it does not apply to properties in Scotland.

**Aggregates Levy**

The devolution of aggregates levy was recommended by the Calman Commission. As this accesses an immobile tax base, we believe that devolving this would not result in substantial technical difficulties. It would also provide an additional (albeit limited) fiscal lever to the Scottish Parliament.

**Q.3 What further financial powers should not be devolved to the Scottish Parliament and why?**

The following should not be interpreted as implying that we believe certain financial power should not be devolved. Rather, our comments are restricted to our assessment of the financial powers that we think would cause most technical difficulties if they were to be devolved.

Generally, a consequence of further devolution will be to increase the administrative burden on both tax payers and the tax authority. Many companies and individuals have bases in both Scotland and rUK. Additional complexity and tax filing obligations will result from the need to take into account the Scottish dimension. This should be borne in mind.

**Income Tax**
We anticipate considerable technical difficulties if income tax on savings income was devolved. Savings income could include dividends, pensions, annuities and trust income. In many cases the party responsible for deducting the income tax (such as a bank, trust or pension provider) would be based in a different part of the UK than the tax payer. The administrative burden would increase considerably. The complexities regarding the UK savings and investment market may also be particularly problematic. In particular, the implications that further devolution in this area would have on pension funds would require serious consideration. We anticipate that a system of foreign tax credit relief (or equivalent) would be necessary which would result in an added layer of complexity.

We also believe that the devolved taxation of savings income would result in considerable cross border implications and would be technically difficult. For example, there is currently a presumption of deduction at the source. Any change to this would create a significant administrative burden. We note that the Unionist parties do not propose devolving the taxation of savings income.

**Corporation Tax**

Considerable technical difficulties would require to be overcome if Corporation Tax was to be devolved. These include difficulties establishing a tax base. Would tax be charged where the income was generated or where the tax payer was based? We do not think that charging the tax on the residence of a corporation alone is workable. Yet recent stories in the press, concerning the tax liabilities of certain multinational companies, demonstrate how difficult it can be establishing the source of taxable income.

The devolution of Corporation Tax would add further complication and increase the administrative burden on corporations with any Scotland and rUK element. Additional administrative burdens would include double tax reporting.

A separate Corporation Tax regime in Scotland and the rUK may also result in tax competition and a “race to the bottom” in an attempt to attract investment. Separate regimes would increase the opportunity for tax avoidance and this would require to be suitably addressed.

Considerable additional complexity would result from the full devolution (i.e. including charging rates, tax base, reliefs) of Corporation Tax – particularly in relation to State negotiations and treaty negotiations. Scotland does not currently have a network of tax treaties as it is the UK that is the signatory to international tax agreements. Westminster would need to legislate to give Scotland powers to negotiate, or renegotiate, treaties, and also to make Scotland a competent authority to deal with any double taxation disputes which arise. Unless they do so, any double taxation issues would be dealt with by the UK,
even in situations where the double taxation arises due to a uniquely Scottish element of a devolved tax.

There would also additional complications from a European Union context as it is the United Kingdom that is the Member State and not Scotland. If a Scottish taxpayer took a case to the Court of Justice of the European Union challenging a provision in a devolved Scottish tax, that would be a case against the UK rather than against Scotland. The question is then how would the defence of such a case be resourced in terms of personnel, legal costs.

We believe that the impact on international tax agreements could be minimised through the negotiation of inter-UK tax agreements which could theoretically leave the position of tax agreements to which the UK is a signatory unaffected. However, efforts to negotiate the position of Scotland vis-à-vis rUK would be considerable.

**Inheritance Tax ("IHT")**

We anticipate considerable technical difficulties in devolving IHT – particularly in comparison to Capital Gains Tax. IHT is a very technical tax and considerable time and resources would be necessary to ensure sufficient harmonisation with rUK.

Perhaps the greatest difficulty would be establishing the tax connecting factor. There would need to be an adherence to the connecting factor in a real way (to avoid people simply moving country near death to attract a better tax rate). Using domicile as a connecting factor would be difficult - even though the current test is of domicile in any part of the UK - because it is a legal, even legalistic, test. It would be likely to lead to uncertainty and litigation. Full devolution of IHT would provide an opportunity for the Scottish Parliament to abolish domicile as the basis of the tax in place of residence, or a variation of the current rule, by which Residence in the UK for 17 years leads to deemed UK domicile status for UK IHT. This would remove a layer of complexity evident in the current system. However, consideration would be required as to the effect of having a different connecting factor in Scotland and rUK.

On the one hand, a situation where old or terminally ill people relocated to Scotland to take advantage of more advantageous IHT rates would be undesirable. On the other, if the IHT bands in Scotland were to be significantly higher than in rUK then some tax payers might seek to avoid establishing a base in Scotland.

**Capital Gains Tax ("CGT")**

Generally, we believe that devolving CGT (or abolishing it in Scotland and granting the Scottish Parliament the power to impose an analogous tax) would be easier to achieve than
devolving Inheritance Tax. However, clarity is required on whether CGT – if devolved – would be calculated by reference to the residence of the tax payer or the source of the taxable gain (or both). We believe that imposing a tax on the source of the gain e.g. property based in Scotland would not be overly problematic. As CGT exists partly to minimise income tax avoidance, the anti-avoidance implications of having two different tax regimes in Scotland and rUK would require serious consideration.

Value Added Tax (“VAT”)

EU Council Directive 2006/112/EC (“the VAT Directive”) requires a single standard rate in each Member State of not less than 15%. There are therefore legal impediments preventing the devolution of VAT.

Nevertheless, to take account of their particular geographical situation (insular nature or remoteness), some limited derogations from this principle have been allowed. For example, Article 104 of the VAT Directive provides that Portugal may apply lower rates in the autonomous regions of the Azores and Madeira than those applicable on the mainland. Article 105 of the VAT Directive states that Austria may, in the communes of Jungholz and Mittelberg apply a second standard rate which is lower than the corresponding rate applied in the rest of Austria (but not less than 15 %).

However, these derogations from the general principle are exceptional. As there does not appear to be appetite to explore the devolution of VAT amongst the main political parties, we offer no further comment on this.

Excise Duties

Excise duties tend to tax items that are mobile– for example, tobacco, alcohol and fuel – therefore we anticipate that to devolve excise duties would result in significant economic distortions. There are also trafficking concerns associated with having different excise duties on tobacco and alcohol in Scotland and rUK.

Q.4 To what extent could the Scottish Government be constrained in how it uses new tax powers given the interaction with fiscal decisions at a UK level?

We refer to our answers at question 1 and 2 above.

Q.5 What are the implications of further fiscal devolution for the block grant?

Naturally, the block grant will be reduced in accordance with the devolution of further fiscal autonomy. We offer no further comment.
Q.6 What are the implications of further financial powers for the role of Revenue Scotland?

The Scottish tax authority responsible for the collection of devolved taxes already exists. As of 1 April 2015, Revenue Scotland will be responsible for the collection of LBTT and Scottish Landfill Tax. However, Revenue Scotland was created with the intention that it would be capable of administering any other taxes devolved in the future. Therefore expenditure to establish a new tax authority for Scotland will not be necessary in the event that further taxes are devolved.

However, additional resourcing of Revenue Scotland would be required in the event of further devolution. It is unclear whether the collection of tax revenues would transfer to Revenue Scotland in the event of further tax devolution (for example, it may be that the responsibility for the collection of income tax remains with HMRC). However, on the assumption that this responsibility would lie with Revenue Scotland, we do have some concerns that it currently lacks the capacity to cope with the increased work load.

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