Scottish Parliament
Devolution (Further Powers) Committee

Implementing the Smith Agreement –
The UK Government’s Draft Legislative Clauses

Evidence from ICAS

6 March 2015
About ICAS

The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent around 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies.

ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. Evidence provided by ICAS representatives’ aims to inform in a positive and constructive manner. ICAS is apolitical and will not take a stand for or against a particular political position. From a public interest perspective in relation to tax, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax system design, and to point out operational practicalities. Our representatives also contribute based on the collective experience of decades of work which ICAS members and staff have undertaken with both the UK and Scottish Parliaments and the tax authorities on the shared agenda of a better-balanced outcome for all tax stakeholders.

General comments

1. ICAS welcomes the opportunity to present its comments on tax aspects in the paper ‘Scotland in the United Kingdom: an enduring settlement’ issued by HM Government in January 2015.

2. The draft clauses in the paper ‘Scotland in the UK: an enduring settlement’ will, in general terms, achieve their objectives of devolving certain powers and taxes. However, questions and issues arise about related non-statutory material and processes, such as how the block grant adjustments may be calculated, and the establishment of the fiscal framework. It is not yet clear how ‘no detriment’ will be interpreted or calculated. These points will have an impact on whether the devolved taxes achieve their aims of greater accountability between the Scottish parliamentarians and their electorate.

3. **Income Tax:** The income tax proposals combine a pragmatic way of devolving further elements of income tax whilst retaining the UK infrastructure of tax collection with HMRC and employers, thereby avoiding the costs and efforts of whole-scale change. At the same time the income tax proposals build upon existing devolved authority because a Scottish rate of income tax (SRIT) is already in place for April 2016, and extend this by offering the Scottish Parliament further decision making and finance raising responsibilities. ICAS recommends that the implementation should be phased in over a number of years. The SRIT planned for 2016 should be permitted to settle in, say over two years, before there is further devolution of income tax.

4. **Capital Gains Tax (CGT):** Clause 12 in the ‘Draft Scotland Clauses 2015’ is a necessary requirement as a consequence of the income tax measures. It is designed to retain consistent application of the CGT rates across the UK.

5. **Aggregates Levy and Air Passenger Duty:** ICAS supports the full devolution of these taxes, as recommended by both the Calman Commission and the Smith Commission. These are standalone taxes that do not have significant interaction with other taxes so they lend themselves to being devolved.

6. **Value Added Tax:** Clause 13 in the ‘Draft Scotland Clauses 2015’ regarding VAT delivers the mechanics of the assignment of VAT, but with the large caveat that it applies ‘where there is an agreement between the Treasury and Scottish Ministers…’. The rules for agreeing this have not been provided and it may not be easy to identify ‘Scottish VAT’.
7. The overall result of the Smith Commission’s recommendations on devolving taxes further will be:

- Three, or more, implementation dates for new tax powers in Scotland:
  - 1 April 2015 for Land and Buildings Transaction Tax and for Scottish Landfill Tax
  - 6 April 2016 for Scottish Rate of Income Tax
  - A date(s) in the future for the Smith recommendations to extend the income tax rates and bands; to devolve Air Passenger Duty and Aggregates Levy; and the assignment of VAT, and

- Three different levels and/or types of devolution:
  - Full devolution - Land and Buildings Transaction Tax, Scottish Landfill Tax, Aggregates Levy and Air Passenger Duty
  - Partial devolution - Income Tax rates and bands
  - Assignment – a proportion of VAT receipts

8. In public usage the phrases ‘Scottish taxes’ or ‘devolved taxes’ tend to encompass different types of devolution and varying amounts of responsibilities, and they lack precision. The nature of the powers with, say, income tax are fundamentally different from those devolved with, for example, Land and Buildings Transaction Tax. There is great scope for confusion in public understanding.

**Issues to be considered in implementing the Smith Agreement**

**Accountability**

With three types of tax devolution proposed, it should be noted that there are fundamental differences between them in both political and administrative responsibilities which, in broad terms, are as follows:

- **Fully devolved taxes – Land and Buildings Transaction Tax, Scottish Landfill Tax, Aggregates Levy and Air Passenger Duty**

  These taxes will be the political responsibility of the Scottish Parliament and the administrative duties are likely to rest with the new tax authority, Revenue Scotland. The nature of the taxes, the legislation, and the associated collection and management duties are fully devolved and completely the responsibility of those in Scotland.

- **Partial devolution - Income Tax rates and bands**

  Partially devolved taxes involve joint responsibilities. Political responsibility will be split between the UK and Scottish Parliaments. The UK Parliament will be responsible for the tax base (what is considered to be income, and how it is measured) and the Scottish Parliament is responsible for the rates and the bands (how much is assessed for collection). Administrative responsibility will remain with HMRC, for which the Scottish Government will pay any additional costs of collection.

  Also note that Scottish income tax rates will be applied to earned income, pensions and rental income, but will not be charged on savings income and dividend income (to ease administrative pressures and avoid distortions of the UK savings market).

- **Assignment - VAT receipts**

  VAT remains the responsibility of the EU (in terms of defining the tax base), and the UK Parliament (in setting the tax rates), with administration and collection by HMRC. How accountability of the Scottish Parliament is arrived at through assignment has yet to be decided and some of the issues around this are discussed below.
Putting the tax receipts in perspective

The main tax revenues attributable to Scotland according to GERS in 2012-13 were:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Revenue £million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>10,865</td>
</tr>
<tr>
<td>Corporation tax</td>
<td>2,872</td>
</tr>
<tr>
<td>CGT</td>
<td>292</td>
</tr>
<tr>
<td>NIC</td>
<td>8,521</td>
</tr>
<tr>
<td>VAT</td>
<td>9,347</td>
</tr>
<tr>
<td>Stamp duties</td>
<td>472</td>
</tr>
<tr>
<td>Tobacco</td>
<td>1,128</td>
</tr>
<tr>
<td>Alcohol</td>
<td>980</td>
</tr>
<tr>
<td>Air passenger duty</td>
<td>234</td>
</tr>
<tr>
<td>Landfill tax</td>
<td>100</td>
</tr>
<tr>
<td>Aggregates levy</td>
<td>45</td>
</tr>
<tr>
<td>IHT</td>
<td>243</td>
</tr>
</tbody>
</table>

Technical aspects

With Income Tax, legislation is already in place to deliver devolved income tax powers to Scotland from 2016, under the Scotland Act 2012. The basic and higher rates of income tax levied by the UK Government in Scotland are to be reduced by 10 pence in the pound and the block grant from the UK to the Scottish Parliament reduced accordingly. The Scottish Parliament has the authority to set its own rate tax to replace this, known as the Scottish Rate of Income Tax (SRIT), which is expected to be considered in the 2016/17 budget that is announced in Autumn 2016.

The next stage in the further devolution of tax powers, the Smith income tax proposals, builds on this by extending the powers over income tax rates and bands, whilst leaving the structure and legislation around income tax as a UK matter, administered by HMRC. This is provided for in the draft clauses in ‘Scotland in the UK: an enduring settlement’.

The timetable to implement this need not be overly long. The requirements to charge Scottish rates and bands of income tax build on existing legislation and administration. However, it needs to be clarified whether the IT changes implemented by HMRC in order to deliver the SRIT will be able to implement the further devolution, or whether further updates will be required. If updates are required, it would need to be considered if the capability is to be built before any changes to rates and bands and, if so, consideration would need to be given to the likely timescales and costs for this. The timetable could also be affected by a need to await the agreement for how the block adjustment is to work (for example, if the personal allowance was radically altered by the UK Government would this be reflected in the ‘no detriment’ calculation?).

With Aggregates Levy and Air Passenger Duty, it will be for the Scottish Parliament to decide its tax policy and to implement it by drafting appropriate legislation. The clauses in ‘Scotland in the UK: an enduring settlement’ are sufficient to take Aggregates Levy and Air Passenger Duty out of the UK charge and to give the power to charge a tax on these types of transactions to the Scottish Parliament.

The timetable around legislating for new devolved taxes may be informed by the work involved to enact the Land and Buildings Transaction Tax (Scotland) Act 2013 and the Landfill Tax (Scotland) Act 2014.

With VAT, the ‘technical’ aspects are not in the legislation; they revolve around how an amount of VAT attributable to Scotland is to be identified and measured, and by whom.
Considerable analytical and statistical work will be required if there is to be an amount that can be identified which truly reflects the VAT attributable to Scotland and will in future reflect any changes in the Scottish economy. Questions include how the VAT statistics are to be arrived at for Scotland; and will this be based on production and value added basis, or on a consumption basis?

To illustrate the potential differences consider the following possibilities:

(a) Production based – products and services have output tax charged at each stage when value is added in the economic chain, and credit is given for this as input tax, until the sale is made to the final consumer. Within the UK, where there is considerable trade between Scotland and the rest of the UK it may be difficult to pinpoint which elements of output VAT, less which elements of input VAT, might constitute 'Scottish VAT', or

(b) Consumption based – the VAT paid when goods and services are sold to a final consumer in Scotland could form a measure but it would not necessarily reflect the productivity or the success of the Scottish economy: much of the underlying work in the goods and services might have been done outwith Scotland or vice versa with Scottish products being sold outside Scotland.

VAT is collected by traders; however, the location of a trader may not reflect where the trade is conducted. For example, a high street chain will probably have one office where the VAT return is collated for all shops across the UK. Also, many larger groups may have a single group registration for VAT.

Any timetable will be dependent on agreeing the basis of calculation.

**Administrative considerations**

**Scottish Income Tax**
Significant preparation has been undertaken prior to SRIT commencing in April 2016; Smith is an extension of this. The following administrative measures are already underway but may need further consideration as SRIT moves from a single rate to full devolution of rates and bands.

**Employers and pension providers** - Scottish income tax will be collected by employers and pension providers. This includes any business with employees in both Scotland and the rest of the UK who will have new ‘S’ payroll codes for their Scottish taxpayers.

There may be some costs associated with the necessary learning about the various changes, adaptation of business systems and reporting mechanisms, as well as the provision of support and advice to employees. Care will need to be taken to avoid confusion with SRIT being introduced in 2016, and then new income tax measures at a later date, yet to be decided.

**Scottish taxpayers** - other practical consequences will be the need to identify a Scottish taxpayer – who are they and who is responsible for their identification? In broad terms, a Scottish taxpayer is someone with their main residence in Scotland. Classification issues are more likely to occur with the top and bottom ends of the income scale; i.e. the very wealthy and more mobile, those who work across different parts of the UK, and migrant low-paid workers.

**HMRC** will continue to collect and manage income tax primarily through payroll (PAYE) and through self-assessment. Points to note include:

- HMRC and also other government departments that are responsible for large operational processes, such as the Department for Work and Pensions, have learnt that large scale change is best dealt with on a step-by-step basis.
- There are extensive, on-going policy changes, digital development and resource consolidation at HMRC, so there may be capability and implementation issues to be identified and addressed as soon as possible in support of the chosen objectives.
Accordingly, for practical purposes, ICAS recommends that the implementation should be phased in over a number of years. The SRIT planned for 2016 should be permitted to settle in, say over two years, before there is further devolution of income tax.

There may also need to be consideration of further operational detail such as the measures around gift aid and charities, particularly if Scottish income tax rates and bands diverge significantly from UK rates.

**Devolved taxes**
Administrative considerations are expected to sit with Revenue Scotland.

**Supporting analysis and policy making**
Care will need to be taken so that plans in the Scottish Government are developed to deliver the financial analysis necessary to support policy decisions. The Government needs to work out how much tax it will really raise, at the different rates of tax, in order to support its decision making.

**Possible unintended consequences**

Future tax policy at both the UK and Scottish levels should allow for a number of influences. First, there needs to be recognition that the different components in the UK tax system are intricately intertwined. Second, tax consequences can be influenced by taxpayer behaviour. As a result, the impact of taxes, and the amounts to be collected, cannot be considered in isolation.

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 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 of whether to extract profits by way of salary or dividend, and
- The different tax consequences between receipts of income or capital.

When some elements are devolved such as income tax on non-savings income, this may open the way to greater complexity, wider differentials and increased attempts at planning to avoid increased tax costs. For example, if income tax rates in Scotland were to increase, then those in family businesses may reduce their salary and increase their dividend payments. This would have two consequences, being (i) a reduction in the overall tax payable, and (ii) a swing from income tax to dividends would mean a decrease in Scottish income tax revenue and an increase in tax on dividends in the rest of the UK receipts. There could also be a question of whether this would impact on ‘no detriment’ calculations.

**Different tax rates and competition**
Differentials and competition may affect the tax rates, as has already happened, for example, with Stamp Duty Land Tax (SDLT)/ Land and Buildings Transactions Tax (LBTT), which may result in:

- Less tax being raised
- Less devolution of responsibility to Scotland, as the SDLT take is reduced so is the corresponding amount in the block grant adjustment
- Greater differentials, and it may be debated whether a particular outcome is tax competition or might be a part of the ‘no detriment’ analysis
- Behavioural impacts by taxpayers (or non-taxpayers), for example, a lack of sales in the upper end of the property market

**Impact on non-tax policies**
The purpose of the assignment of VAT is to align tax income with the economy, but if this is so, it may be that VAT receipts could become a measure of the Scottish economy. This in turn might influence the Scottish Government’s economic support programmes with support targeted at areas that would grow the economy (in other words, the VAT take if this becomes
a measure). Such targeting could therefore be at the expense of VAT exempt businesses (such as financial institutions) or zero rated businesses (such as the food industry).

**Hypothecation**
If income tax is to become ‘Scottish’ does this mean that it will be hypothecated to devolved responsibilities such as health and education?

**Corporation tax**
Whilst it has been agreed in the Smith recommendations that corporation tax will not be devolved, this topic may remain open if only because corporation tax rates are to be devolved to Northern Ireland.

**Public awareness**

**Public awareness campaign**
As Lord Smith noted in his report, a challenge facing both the UK and Scottish Parliaments is the relatively weak understanding of the current devolution settlement. This is equally so regarding taxation. In particular, it would be helpful if there was a wider awareness of:

- The Scottish Rate of Income Tax, and that there are already measures in place so that Scottish politicians will be setting a significant proportion of the income tax levy for Scottish taxpayers from 2016 onwards, and
- More widely, the way in which the different devolved taxes work so that there can be greater accountability.

ICAS recommends that there should be an immediate public awareness campaign led by policy makers. It should also include greater awareness of the operational consequences, such as decisions about establishing who is a Scottish taxpayer and that responsibility for collection will fall on payroll operators to operate ‘S’ payrolls.

**Transparency for taxpayers**
A conundrum associated with the levying of tax is that policy makers will seek to raise as much as possible but without drawing undue attention to this, in colloquial terms, plucking the goose with as little hissing as possible. This, however, does not necessarily lead to transparency for those paying the tax, or a sense of responsibility and pride in contributing to the public purse, nor does it necessarily lead to a sense of accountability between those paying and spending. A clear and transparent message to taxpayers and citizens is required.

**Setting the tone**
The possibility of tax planning consequences arising out of the devolution of certain taxes needs to be factored into the proposals. The Revenue Scotland and Tax Powers Act 2014 introduced a General Anti-Avoidance Rule for fully devolved taxes that is different from the UK General Anti-Abuse Rule, and sets out to take a stronger stance against tax avoidance. There is a danger, however, in setting the right tone about compliance and public duty if the rules are overly complicated, the law permits different opportunities, and there are confusing messages about anti-avoidance.

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1 Note: these are extracts from GERS, the full figures may be found at Table 3.1, page 28 [http://www.gov.scot/Resource/0044/00446179.pdf](http://www.gov.scot/Resource/0044/00446179.pdf)