SUBMISSION FROM THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

In the third reading of the Scotland Bill conducted on 21 June 2011, Mr Reid, the Honourable Member for Argyll and Bute, commented at Column 265 that:

“The Scottish Parliament already has more than a putter, and the Bill would give it a lot more clubs in its bag”.

Income Tax

The amended Bill published on 22 June 2011 contains a number of new clauses but our comments, in broad principle, made about the previous Bill remain valid.

Taxation does not stand still and the UK Government has published a consultation which proposes to introduce a statutory definition of residence. We commend the Government for this action as we believe this is a step in the right direction, but we retain concerns that the proposed statutory definition introduces anomalies and uncertainties, although it is a considerable improvement on the current unsatisfactory and uncertain position regarding UK residence and domicile for taxation purposes. We attach at Appendix 1 a copy of our representations to HM Treasury on such points for those interested in these complexities.

The Institute of Chartered Accountants of Scotland does not comment on the political decision to vary a Scottish rate of tax. Under the old Bill, clauses 28 to 32 operated to allow the rates of income tax which are set annually by the Government, to be reduced for Scotland by 10p in the pound. The Scottish Parliament will then levy a single rate of income tax which will apply in Scotland in addition to the UK rate. The Scottish Parliament could choose a 10% Scottish rate which would restore the overall rate of income tax back to the levels in the rest of the UK, or it could choose a higher or lower rate. Experience from other jurisdictions shows that variable State taxes are practical provided the definition of the right to tax is clear to all concerned.

Other elements of the UK income tax structure such as the measure of income and the description of the income (whether it is earned income or savings income) will remain the exclusive responsibility of the UK Government and UK Parliament.

The Bill provides that the Scottish Parliament will be able to choose only a single rate which will apply to all the UK rates of income tax; the basic rate, the higher rate and the additional rate.

We make no comment on whether or not these political decisions will achieve the purpose behind the Scotland Bill provisions which we understand are to extend the responsibility of the Scottish Government for raising (as well as spending) public money.
The objective is to increase the accountability of the Scottish Government to the people of Scotland.

Lord Wallace of Tankerness observed at Column 159 of the Lords’ Hansard for 6 September 2011 that:

“The financial powers contained in the Bill are, as I have indicated, the largest transfer of financial powers out of London since the United Kingdom was created. The Parliament will become accountable for raising more than a third of the money it spends”.

In our previous submission, a copy of which is attached, we observed that the Scotland Bill devolved landfill tax, stamp duty land tax and the power to create new taxes. In our response we do not comment on landfill tax or stamp duty land tax and largely concentrate on trying to ensure that the Bill is able to achieve its objective without imposing additional and unnecessary compliance costs on compliant Scottish taxpayers.

The Bill continues to pose questions which remain unanswered. If a differential rate is introduced, what will be the cost to business and, in particular, what will be the cost to employers throughout the UK who have Scottish employees? The same point of principle applies to annuity providers.

It is important that the administrative burden is kept to the absolute minimum so that the cost of compliance and collection of tax in Scotland does not alter from that of the rest of the UK.

The primary problem remains how to achieve certainty in the definition of “residence” and how to strike the right balance between people’s right of privacy and the need to check days spent in Scotland for people who are itinerant workers or who move around within the United Kingdom. Scrutiny and debate on these issues continues to be essential.

It is important that all citizens affected by tax raising powers view the powers as fair and acceptable. With a self-assessment regime, it is important that in defining who is liable to a taxation there is clarity and certainty in the legislation. The Scotland Bill is faced with a difficult task of defining who is a Scottish taxpayer.

Before concentrating on this difficult area, we remain concerned at the potential for abuse because savings income will not become liable to Scottish taxation. The unintended consequences of taxation changes are often embarrassingly apparent. For a short period, the previous Government introduced a nil rate of corporation tax which then encouraged a number of businesses to incorporate to obtain the benefit of that nil rate of corporation tax and to extract profits by way of dividends.
The debate on the Scotland Bill taxation provisions takes place against a theoretical assumption that the difference between earned income and savings income is clear. That assumption is not sound and if a Scottish taxation rate was adversely affecting people, there is the possibility that they would be tempted to incorporate their activity, converting their earnings into dividends.

As we said in our previous submission, disputes over the right to tax and the definition of a Scottish resident taxpayer could cause poor compliance, confusion and excessive cost. It is therefore in everyone’s interest that this problem is addressed at a practical level. Modern computerised payroll systems can cope with differential tax rates but if cost is to be kept down there must be certainty as to whom the differential tax rates apply.

At present, HMRC requires over 8 million people to self-assess but the vast majority of earners are employees and their tax liability is dealt with by PAYE and only occasional returns being made. Modern working practices including greater employee mobility, electronic communication and increased part-time and short term working means that this issue of the practicalities of residence must be addressed.

Clause 30 introduces the Scottish rate of income tax and a new section 80D to define Scottish taxpayers setting out the conditions A, B or C which involve date counting.

Section 80E introduces the concept of the close connection with Scotland but by section 80E(3) we have the concept of main place of residence involving date counting instead of looking at the quality of occupation of a particular residence.

Enacting poorly drafted legislation is in no one’s interest and taking expedient steps like the proposal in section 80G(1) to allow a Treasury Order to exclude the effect of the tax varying power in relation to any enactment is not really creating the certainty which the legislation deserves. We understand the difficulty in determining how tax reliefs such as gift aid or pension contributions have to be dealt with, but we think that the legislation should be drafted making all these points completely certain, rather than enacting something that leaves matters of some difficulty and complexity to be resolved at a later date by a Treasury Order.

We commend the Government for its wish to discuss with the relevant stakeholders these issues, but we would prefer to see the legislation enact a final treatment for dealing with reliefs, and for the matters to be dealt with in primary legislation.

The need for section 80G(3) appears to arise if there are delays in the Parliamentary process such that the Scottish Parliament did not pass a resolution or the UK Government did not make a decision. We do not think that it is appropriate to enact powers which anticipate defaults by Government and it would be better to ensure that the Parliamentary process is strictly applied and that all Parliamentarians are aware of the need to enact clear and certain legislation.
In some cases the legislation provides a mechanism whereby after the year-end, and by counting the days, it is possible to decide whether or not somebody is a Scottish taxpayer. However, if this decision is made after the year-end, there requires to be a clear understanding of the reporting requirements. In particular, a clear understanding is needed of how delays and failures will interact with the penalties legislation, which is found in various Finance Acts including schedule 24 Finance Act 2007, as well as the interest regime and surcharge regime (schedule 53 Finance Act 2009).

Our recommendation is that steps need to be taken now to create a register of Scottish taxpayers and that every effort must be made to keep the cost of compliance to all UK businesses and individuals as low as possible. Our understanding is that HMRC have no intention to introduce a concession to split the fiscal year to deal with movements. We remain convinced that this is unacceptable.

**Corporation Tax**

We attach at Appendix 2 a copy of our representations to the Scottish Government on such points for those interested in these complexities.
APPENDIX 1

Statutory Definition of Tax Residence: A Consultation

ICAS response to HM Treasury

Introduction

The Institute of Chartered Accountants of Scotland (ICAS) strongly supports the Government’s objective of replacing the current uncertain and complicated residence rules with a clear Statutory Residence Test that is simple for the taxpayer to use. We have long supported the need for a statutory test for determining residence.

The proposed changes are welcome to the extent that they would bring increased objectivity to the process of determining residence and therefore greater certainty for taxpayers. If designed with simplicity and clarity in mind, a new approach such as this could reduce compliance burdens, and this could benefit both taxpayers and HM Revenue & Customs.

We also support the sub-division of the SRT into three parts – conclusive non-residence, conclusive residence, and others. This framework is helpful in providing a clear structure to the SRT. We hope that Part C could be kept sufficiently simple that it would make the position clear and objective even for those coming within that category, but we fear that this would not be achieved by the proposals as they currently stand.

We consider it unacceptable that the SRT should apply only for income tax, capital gains tax and inheritance tax but not for national insurance contributions at a time when there are moves afoot to integrate the operation of income tax and NICs. Similarly, we think it unacceptable that the concept of ordinary residence should be retained for NICs while being substantively abolished for other taxes.

Proposed Framework

While we accept that Treasury are setting out to codify the legislation, the proposals are silent on the effect of former interpretations where the taxpayer is resident in a treaty partner. We would have expected this to be mentioned at paragraph 3.10. If the effect of the SRT were to make UK resident a treaty partner resident who was not UK resident under the pre SRT test, the pre SRT test would appear to us to take precedence until the relevant treaty is renegotiated. We should welcome clarification from Treasury on this point.

The proposed tests set out in paragraph 3.17 seem unforgiving compared to the 90-day or 183-day rule. We would agree that the proposed let-outs offer a simple ‘safe harbour’, but we would suggest that longer periods in the UK should be allowed while still preserving non residence.
Responses to questions contained in the consultation paper

Residence test – Part A:

- **Question 1: Do you think there are any other circumstances in which an individual should be conclusively non-resident? If so, what are those circumstances?**

  No, except for our suggestion (above) that there be a lengthening of the periods of UK presence allowed under paragraph 3.17.

  For the purpose of applying the third bullet point under paragraph 3.17 (to those who leave the UK to carry out full-time work abroad, provided they are present in the UK for fewer than 90 days in the tax year and no more than 20 days are spent working in the UK in the tax year), we believe the definition of ‘full-time work abroad’ is too stringent. The requirement to work 35 hours a week seems unduly onerous, and this will force many to restrict unreasonably their days back in the UK. We comment further on this in our response to Question 5(a) below.

Residence test – Part B:

- **Question 2: Do you think there are any other circumstances in which an individual should be conclusively resident? If so, what are those circumstances?**

  Yes. In respect of UK earnings, those who are employed in the UK by a UK employer for any length of time should pay UK tax on those earnings. This should apply especially to those whose only or main employment or self-employment is carried on in the UK.

  This should include, for example, the Premier League footballer from abroad, who spends between 90 and 119 days in the UK, training and playing – an average of up to three days per week over the 40 week season and never more than three hours per day. His wife and family are not resident but spend substantial time in the UK. He lives in a hotel. It would take two or more factors to make him UK resident, but the only factor existing (if indeed it does) is the 90 days or more in either of the previous two tax years. The footballer coming to the UK for the first time, with or without a non-resident family and living in a hotel, could stay longer and spend up to 182 days and pay no UK tax on his earnings.

  The test in Part B would be acceptable subject to the exclusion of the ‘only home’ test in periods of leave taken outside the UK where in full-time employment. An individual may have a contract which involves (say) a period of 8 months across two tax years. If that individual is at the early part of their career they may only be in the rental market. A person later in their career may have a home elsewhere, leading to a different outcome on residence. It seems capricious to
include a test related to availability of accommodation where the individual is full-time employed outside the UK.

There is a conflict between the aim of ensuring that high earning arrivers pay tax in the UK, and the need to make the UK attractive to business entrepreneurs and investors – many of whom are much more freely mobile than (for example) high-flying celebrities. In our response to Question 3(b) below we have alluded to special arrangements that some countries offer inbound expatriates, limiting the impact of high personal taxes on their earnings, and we think that such arrangements might be used to advantage.

**Residence test – Part C:**

- **Question 3(a): Do you think that these connection factors are appropriate and are there other connection factors that should be included?**
  
  The proposed connection factors are broadly appropriate. However, we believe the substantive work test would be impossible to police and should be omitted or modified. The old test of ‘nothing other than incidental duties of the employment performed in the UK’ would be a better test to adopt.

- **Question 3(b): Does this part of the test provide a fair outcome? If not, why not?**

  No.

  There should be no distinguishing of relatives from other providers of temporary short-term accommodation. The ‘substantive employment’ test could be difficult to measure and would be impossible to police. It should be replaced by a ‘no more than incidental duties in the UK’ test.

  The way in which the proposed connection factors are taken into account may be unfair, and the examples quoted in the consultation paper are not in sufficient detail to illustrate this. For example, in 2013/14 Mrs E’s family decided to move to France permanently and Mrs E sold the family home in the UK. If the family resided in the UK until the family home was sold on (say) 10 April 2013, there would be 3 connection factors (not 1) for 2013/14. It is naïve to offer an example which assumes that the move to a different country and the sale of the UK home all take place on 5 April.

  In general we feel that the new regime would not achieve a fair result for arrivers. For example:

  - Two people come to the UK to perform identical jobs. A is married and brings his family to the UK, and has available accommodation here for his family. B is unmarried but has available accommodation here. Both travel
extensively in the course of their duties, but each spends 95 days a year in the UK – 60 of them as working days.

- A has 3 out of 4 factors so can spend up to 89 days in UK, including working days, without becoming resident. B has only 2 out of 4 factors and so can spend up to 119 days in the year without becoming resident. Therefore A is resident but B is not. There seems no logic in this distinction.

- In the following tax year, A (having already been resident for a year) has 4 factors and therefore cannot be present in UK for more than 10 days without becoming resident. If he were to alter his circumstances to meet this condition, it would follow that he no longer has substantive employment here and therefore he would have only 3 factors – so he could be in UK for up to 44 days without becoming resident.

- All this is just too complicated. Having family in the UK and/or accommodation available in the UK should be a single test – not two separate conditions.

- Legislation such as that proposed would make the UK less attractive to use as a base. If Britain does not attract key senior personnel, we will lose decision makers and headquarters operations to other countries because of our high tax regime. By comparison, for example, both Belgium and Denmark have special arrangements for inbound expatriates which limit the impact of high personal taxes on their earnings.

- On a point of detail, it is unclear to us how PAYE would be administered. Would all arrivers employed in the UK by UK employers be coded BR, pending the determination of their residence status?

In general we feel that the new regime would achieve a fair result for leavers. In that regard, one of our members who recently left the UK for full-time employment abroad has trialled Treasury’s interactive online tool in his own circumstances and found it simple and effective to use and apparently accurate in its outcome (assuming that the proposals had been enacted). Although we have not been able to test the tool further, we feel that HMRC should be commended for providing such a straightforward support for the proposed legislation. It will be important that, when operational, the online tool is capable of evidencing the result which a taxpayer reaches after use of the tool.

Redidence test:

- Question 4: Would the lack of a transitional rule as described in paragraph 3.57 leave significant uncertainty?
Yes – otherwise the Government’s case for introducing the SRT is defeated.

The absence of a transitional rule could leave significant uncertainty, and this would be relevant to both arrivers and leavers. It would be helpful if, for the purposes of determining your status going forward where your historic status is relevant, you should be able to apply the new rules to determine what your historic status would have been if they had been in place.

There would be uncertainty despite the view of residence status taken in prior returns. Many taxpayers would not have filed returns. It would be clearer if the taxpayer was given the option, either to accept prior residence, or to apply the new rules to determine residence status for prior years when testing residence for 2012/13 onwards. This would greatly ease administration.

**Residence definitions**

- **Question 5(a): Do you think that the proposed definitions are appropriate?**

  No.

Paragraph 3.30 defines as relevant the connection factor that the taxpayer spends more days in the UK in the tax year than in any other single country. This raises two points:

  - The answer to this question will not be known until after the tax year has ended, and very possibly after an arriver has subsequently left the UK. (The tables set out in paragraphs 3.35 and 3.37 are clear. For arrivers and departers the difficulty will arise when it comes to determining whether or not certain of the connection factors exist. HMRC will have the triple difficulty of determining whether or not the factors exist, whether day counting has been done properly, and how to collect tax from arrivers who leave after a while, never to return.)

  - In preliminary discussions, Treasury have agreed to clarify how this provision will be applied when the other country is one that does not impose taxes similar to income tax, CGT and IHT – for example, Dubai.

Paragraph 4.2 defines full-time work abroad (FTWA) and we believe the definition fails to reflect the realities of modern working. It is unreasonable to base this on an expectation that employment or self-employment abroad will involve as much as 35 hours per week – especially when working habits and customs vary from country to country. We believe the definition should be based on a lower number of hours combined with a qualitative test – for example, it might require the work abroad to be the ‘only or main employment’.
Paragraph 4.10 states that where individuals work in the UK for less than three hours on a particular day they would be expected to have sufficient records to demonstrate this fact. This requires the taxpayer to prove a negative, and this would be impractical. How can this possibly be policed? How do you evidence the fact that you have not been somewhere not doing something?

If it had to be used, there would be a need to provide a much clearer definition of a 'working day'. How would this work in practice, taking account of the fact that people are mobile and do not necessarily sit at a desk and work for three hours (or more) at a stretch? For example:

- The definition of a working day is one during which more than three hours of work is undertaken. Are tea, smoking breaks, toilet breaks and fire drills etc included in the three hours? Is health and safety training or suchlike regarded as work?

- Would contractual hours of work be considered relevant? If so, how would flexible working arrangements be regarded?

- If you come to the UK for a business meeting (or other event) does only the duration of the meeting count, or is the travelling time either side included too, i.e. if you come to the UK specifically for a meeting, do you count the time from when you arrive at (say) Heathrow to when you leave it again later that day?

- In preliminary discussions, Treasury have indicated that in addition to the legislation there will be guidance on the definition of 'work', but it is not intended that the guidance will differentiate between different types of work, e.g. reading emails on a Blackberry, setting up an appointment or attending a meeting. From an evidential perspective, we think this ignores the fact that there may be substantial thinking time involved in preparing for particular work activities, and yet there may be no evidence of this available. For example, a short email may result from an hour or two of careful deliberation.

- From an evidential perspective it might potentially be easier to fix the definition of 'work' by reference to presence/attendance at a specific location, e.g. a meeting, a seminar or an office. This could theoretically remove the potential issues of being required to evidence thoughts, but such an approach would operate very unfairly against some mobile workers.

- Following on from the last point, how could home working be dealt with in such circumstances, i.e. how would you be expected to evidence when you were or weren’t working?
Paragraph 4.11 states that the definition of a day of presence in the UK will remain unchanged. In preliminary discussions, Treasury have agreed to address the proposed treatment of unavoidable delays for those in transit who are forced to stay longer than planned in the UK (e.g. because of ash clouds) and those forced to return prematurely to the UK (e.g. from trouble spots such as Libya).

Paragraph 4.19 refers to ‘common law equivalent’ and it is unclear to us what this means. If it is intended to refer to a cohabitee, a clearer definition would be required. We think that Scotland may be unique in the UK in having a common law equivalent of a spouse in the form of a ‘marriage by habit and repute’ – now abolished except for pre-2006 relationships, and this common law concept does not extend to same sex relationships. HMRC do not accept cohabitees as being entitled to tax reliefs and exemptions available to spouses, and civil law does not generally recognise cohabitees as having rights equivalent to those of spouses – although Scots Law does to a limited extent but this requires a surviving cohabitee to make application to the Court.

Paragraphs 4.19-20 (as we have already pointed out in preliminary discussions with Treasury) might force differing behaviour for some in terms of how often they see their children and for how long. The tax rules might thus add unwanted tensions within families and work against the better interests of children, especially when seeing a child by a non-custodial parent outside the UK can be counted. This is an area of serious concern.

Paragraphs 4.21-22 provide definitions of ‘accommodation’. This raises the following points:

- Elsewhere the consultation document uses the term ‘home’, and we think there may be a need to define this also.

- If there is intended to be a distinction between a ‘home’ and ‘accommodation available’, can this be clarified? We understand from preliminary discussions with Treasury, for example, that a house left devoid of furniture etc is unlikely to be a ‘home’ but might be regarded as ‘available accommodation’.

- If an individual owns a UK property but it is undergoing wholesale long term renovation or refurbishment such that it is not fit to be lived in, will it count as available accommodation?

- Can it be confirmed that a property would not need to be owned to be a home.

Paragraph 4.22 refers to accommodation accessible to a child of the individual under the age of 18 where that accommodation is provided in relation to the child being a student at a UK educational establishment. We believe that this should
extend to accommodation owned or let to enable the child to attend the educational establishment, and should not be restricted to accommodation provided at or by the educational establishment. We would appreciate clarification on this point.

Paragraph 4.22 also refers to short-term accommodation in hotels. In this connection:

- ‘Short-term’ would need to be defined.

- It is unclear whether ‘short-term accommodation in hotels’ would be defined by the length of the stay in one or more hotels during the period spent in the UK, or by the nature of the contract between the individual and the hotel proprietor(s).

- How would accommodation in a serviced apartment be regarded? It would be unusual to have a lease of such an apartment, and it would not generally be classified as a hotel.

Paragraph 4.22 also refers to lodging with relatives, where staying in the home of a relative is for a temporary short-term visit only. What is a relative? What is short-term? Why, for this purpose, should relatives be regarded as different from friends or any other accommodation provider? Why should the ownership of the accommodation matter, so long as it is not owned by the taxpayer himself? There is no logic for distinguishing between relatives and other providers of temporary short-term accommodation, and we believe that no such distinction should be made.

Paragraphs 4.23-24 refer to substantive employment (including self-employment). In our view the ‘substantive employment’ test could be difficult to measure and would be impossible to police. The substantive employment test should be replaced by a ‘no more than incidental duties in the UK’ test – subject to the further change which we have suggested in relation to self-employment.

- **Question 5(b): Would these definitions have an adverse impact for particular groups? If so, which groups and what would the impacts be?**

We have concerns about the treatment of self-employed persons, as follows:

- For the self-employed, full-time work abroad (FTWA) is defined as carrying on one or more trades or professions wholly abroad where 35 hours of work per week or more is undertaken on average. Then we are told that for a person to be FTWA, no more than 20 working days can be performed in the UK in any one tax year.
It is conceivable that (say) a partner could meet both these definitions – working for one partnership whose trade is carried on wholly abroad and also coming to the UK to work in a different trade for less than 20 days.

Far more likely is a situation where a partner is based in an overseas branch office and spends more than 35 hours a week on average carrying on the trade from that office, while also occasionally coming to the UK and delivering services out of the UK branch office but for less than 20 days in total.

In the former case the partner would be non-resident. In the latter case they would fail the ‘wholly’ test as they have carried on part of the trade while in the UK. The partner in the latter scenario would be spending no more time and generating no more income from the UK than the partner in the first scenario – but their residence position would be different. This seems unjustified.

The solution would be to drop the reference to ‘wholly’ in the definition. A self-employed person would then be tested in exactly the same way as an employee: average working hours overseas, duration of period, and limitation of working days back in the UK.

Part-time workers – both employed and self-employed – would be adversely affected if the FTWA rules were not addressed. A particular example of this would be a person who works full-time abroad, partly in employment and partly in self-employment; under the proposals they would not qualify as being in FTWA.

We have not identified any other groups that we believe would be adversely affected more than others.

**Ordinary residence:**

- **Question 6(a): Should ordinary residence be abolished for all tax purposes other than overseas workday relief?**
  
  Yes.

- **Question 6(b): If a new definition of ordinary residence was introduced, should it be restricted to non-domiciled individuals only?**
  
  Yes.

It is difficult to see why a UK domiciled individual would be resident but not ordinarily resident or, in the few cases where this apparently arises, why there should be special rules for such an individual.
• Question 6(c): Is the proposed definition of ordinary residence appropriate? If not, are there alternatives that would not have a material Exchequer cost?

No.

We think that there are deficiencies in the way both the current rules for determining ordinary residence and the proposed definition of ordinary residence assess whether the individual is coming to the UK with the intention of settling here permanently. For example:

- Under existing rules the terms of a contract of employment may assume particular significance, but in reality the individual may have no intention of remaining in the UK throughout the period of their contract.

- The proposed definition of ordinary residence will rest heavily upon whether the individual’s only home is in the UK. However, an arriver’s decision not to retain a home abroad may arise from a number of unrelated circumstances – for example, they may be early in their career and have amassed insufficient assets to retain a home abroad, they may have disposed of their family home in a divorce settlement, or they may be facing financial difficulties for other reasons. None of these factors suggests a degree of permanence in their plans to settle in the UK.

In the interests of simplicity, we suggest that the proposed statutory definition of ordinary residence in paragraphs 6.16 and 6.17 should look at the previous three years instead of five.

Conclusion

We are wholeheartedly in favour of the adoption of an SRT to provide greater certainty and simplify tax compliance. The proposals represent a considerable improvement on the existing regime.

Many of our points of concern relate to the proposed treatment of arrivers. For them certainty is crucial – otherwise they may be persuaded to go elsewhere. In general, therefore, the proposals need to be amended to make them more generous and more helpful to arrivers.

We would also like to see the SRT providing greater simplification for those with complex affairs who face particular difficulties in applying the current rules. Many of these are individuals associated with potential inward investment and possible UK headquarters operations, and it is vital that the new regime is geared towards making Britain a more attractive place for them to do business.

The legislation and operation of the SRT should be reviewed after one year of operation.
About ICAS

The Institute of Chartered Accountants of Scotland is the world’s oldest professional body of accountants, having received its Royal Charter in 1854. Since then ICAS has played a leading role in the accountancy profession. The Institute’s main objective is to uphold the integrity and standing of the profession of chartered accountancy in the interests of society and the membership. We have approximately 19,000 members spread throughout the world and many chartered accountants hold key positions in commerce, industry, the public sector and private practice.
APPENDIX 2

Corporation Tax Discussion Paper
Options for Reform

ICAS response to the Scottish Government

About ICAS

ICAS is the professional body of CAs (Chartered Accountants). We are an educator, examiner, regulator, and thought leader. We represent nearly 19,000 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, while a third work in accountancy practices. ICAS members play leading roles in 80% of the FTSE 100 companies. We are consulted on our expert opinion on matters such as tax, financial reporting and business policy by the Treasury, the UK Government, the Scottish Government, HMRC as well as international organisations and governments around the world. These expert opinions are formed in consultation with committees of senior members, including an international tax sub-committee and a corporate tax sub-committee. We are the first professional body of accountants, formed in 1854.

Executive Summary

ICAS welcomes the opportunity to comment on the issues around devolving corporation tax powers to Scotland. In June of this year we submitted to HM Treasury comments in relation to similar discussions on devolution of corporation tax for Northern Ireland. A copy of that submission is attached at Appendix 1 for ease of reference.

Ultimately, the Scottish Government’s paper “Corporation Tax: Discussion Paper Options for Reform” (“the Discussion Paper”) is about control over Scotland’s affairs, which is a political decision. The voters of Scotland will continue to decide Scotland’s political direction. Yet it is the businesses in Scotland, elsewhere in the UK and overseas who will decide whether to invest in Scotland. Our members work in senior positions in these businesses and this submission reflects their views on this discussion initiated by the Scottish Government. We believe informed debate is valuable on this subject. Our members make up the single largest group involved in the application of corporation tax policy in businesses in Scotland. The issues raised by ICAS in this debate, are in the following areas:

- Tax competitiveness
- Tax complexity
- The definition of the tax base
- Transfer pricing and profit shifting
- The tax compliance and collection burden
Our views are based on the experiences of our members operating in, and advising, many large businesses currently in Scotland and elsewhere in the UK.

In broad terms, our members continue to support lower taxes for business as a driver of growth and success. Our members believe in encouraging more global companies to be headquartered in the UK and Scotland. Our members believe Governments should implement policies which encourage entrepreneurship and business growth. This submission accepts those basic principles and seeks to build on them. We contribute to the debate on the details of implementation of the devolution of corporation tax, in the public interest, in order to prevent the unintended consequences which often arise from changes to tax policy.

1. We believe that further work and evidence is required to ascertain what the actual economic impact of devolution of corporation tax to Scotland would be. This remains unclear at the moment. What would the economic impact be and when?

2. We believe that a broader view of the drivers of economic success needs to be considered when debating the likely impact of devolution of corporation tax. Will companies make strategic decision based on corporation tax rates alone or what other conditions drive decision making?

3. We believe further work would be required on assessing the impact on the public finances if there were to be a short, medium or long term reduction in tax revenue due to a lower rate of corporation tax being levied in Scotland. What will the revenues be?

4. We believe that the constituent parts of the tax base need to be defined. In other words, which companies would pay corporation tax in Scotland? 81% of corporation tax in the UK comes from 1% of the companies. What proportion of this tax would be payable in Scotland? This needs defined before we can estimate the shortfall or surplus compared to current revenues.

5. Finally, our members have expressed concerns that if a separate tax authority were set up to administer corporation tax in Scotland they would not welcome the potential complexity and burden of dealing with two tax authorities – the Scottish Tax Agency and HMRC.

We note that an ongoing discussion has been suggested and we look forward to contributing to the debate.

**Overview Comments**

The concerns expressed in the final report from the Calman Commission published on 15 June 2009 as “Serving Scotland Better: Scotland and the United Kingdom in the 21st century (Final Report)” remain. That report is just over 2 years old and remains an important influence on the current discussions. There have been some developments
since then pertinent to those discussions which merit explicit consideration in this response.

1. The UK Government has recognised that corporation tax rates worldwide are reducing and that the competitiveness of a tax regime – in terms of the corporate tax rate, tax base, targeted incentives and administration – is essential. This point is the same as that highlighted in the discussion paper and, at a general level, is accepted. Steps have been taken since the General Election in May 2010 by the UK Coalition Government to address these issues, for example in the announced reduction in the main corporation tax rate from 26% to 23%, the reform of the Controlled Foreign Companies regime, a review of the incentives for Research and Development tax credits, the establishment of the Office of Tax Simplification and the work on performance standards in HMRC called for by the Treasury Select Committee. We believe that the scope for benefits perceived for a differential regime in Scotland is limited by the parallels offered so far between those called for in the Discussion Paper and those already announced by Westminster. Both Governments appear to share the need to close the gap between the attractive features of, for example, the tax regime in the Irish Republic and that of the UK, although EU pressures raise uncertainty as to whether the Irish rate is sustainable in the long term.

2. We consider that the discussion on the economic impact of the powers sought in relation to the Scottish economy has been emotionally empowering, but the economic case has not yet been demonstrated to the standard that might be expected to build a persuasive intellectual argument for support by our members. Further information is necessary to consider if, or how, this might change the balance of views expressed so far. A number of areas for future attention arise.

1. The discussion paper quotes the statistical outcome in terms of jobs and economic growth for Northern Ireland produced by The Economic Advisory Group report “The Impact of Reducing Corporation Tax on the Northern Ireland Economy” of May 2011, yet there has been no equivalent economic model produced for the Scottish economy, where the industry sectors, research base, skills and employment market and economic volatility challenges differ from those in Northern Ireland.

2. The statistics quoted do not address the situation where it is possible that both Northern Ireland and Scotland, and perhaps also Wales and/or regions of England are permitted devolved powers over tax and reduce the corporate tax rate to 12.5%. At the same time the Discussion Paper recognises the point of principle of the equality of power that should be granted to the different jurisdictions is a relevant factor that might inform this debate. Without this information, the “race to the bottom” concern remains unaddressed. Knowing who your competitors are is at the heart of being competitive.
3. Whilst low tax regimes, such as Estonia and Ireland are referred to in the Economic Advisory Group report, neither is necessarily a role model in terms of overall stable economic success, and Ireland in particular has been heavily reliant on the success of the German economy, with corporate tax rates of 33-41% (recently announced to reduce to 23-33%), to provide a financial support package in recent months. We agree that a broader view of the drivers of economic success need to be considered as a package, but it is not the case that the tax rate in isolation provides a long term solution. Indeed, the success of Scottish Development International in attracting Foreign Direct Investment to Scotland, as referred to in the Discussion Paper, somewhat contradicts the arguments put for a cut in the tax rate in isolation.

4. The potential volatility of corporation tax receipts in Scotland has been identified as an issue in the Discussion Paper, although one commentator stated this was less of an issue if the expectation was that these contributed only around 15% of the current Government Budget. This raises one of the key points of detail which is not adequately addressed, that of the nature of the tax base assumed in the Discussion Paper. The HMRC statistics identify the corporation tax receipts of businesses registered in Scotland, yet tax regimes across the world, and according to established OECD models, regard the taxable profits of businesses as made up broadly of companies registered in a jurisdiction, plus those registered elsewhere but operating there through branches and permanent establishments, less the profits of operations in branches and permanent establishments undertaken in overseas tax-paying jurisdictions. (This leaves aside any discussion on whether that tax base decision is out of date, given that it does not fully reflect how modern technologies have enabled different business operational models to emerge). The Discussion Paper is silent on what the definition of the Scottish tax base is to be, but this would be an identifiable and widely accepted model to adopt. That raises the issue of the complexity of operating a separate Scottish tax base in the future, when many UK companies have not had to identify how their geographic operations relate to their original corporate registration within the UK (Scottish or English for example). After acquisitions or mergers, or as a result of business name registration, in practice it is highly possible that there is no clear identity between the jurisdiction within the UK of the registered company of a business and its taxable operations. It also opens up the complexity to be resolved by both Westminster and Holyrood in determining the value of corporation tax receipts in Scotland, and whether 15%, as in the Discussion Paper, is the right proportion of the Scottish budget that might be exposed to the volatility identified in those corporation tax receipts. Whilst volatility, according to the Discussion Paper, is potentially to be met by borrowing powers, we note that a similar solution is proposed for income tax volatility in the Scottish Government’s submission in June 2011 to the UK Government on borrowing powers in the Scotland Bill; an integrated approach would be needed and further exploration of how potential volatility in both corporation and income tax receipts might be accommodated is required as part of any future informed discussions.
5. Concerns have been expressed by some members over whether the complexity of the tax base calculations or additional compliance burden may result in some businesses removing operational bases from Scotland. This was suggested if the benefit of a lower corporate tax rate, particularly for a business of low profit margins, was outweighed by the additional compliance burden and costs in meeting filing obligations. The impact on business sectors in Scotland which currently have special corporation tax regimes, such as life assurance companies, is still to be explained. The possible balance of the behavioural impact of different businesses and consumers is another relevant factor for economic research and modelling. Tax is often an area with unintended behavioural consequences.

Overall, this suggests to us that a fuller, proper consideration of the levers of Foreign Direct Investment as well as wider economic success in Scotland, such as small business finance and employment skills, beyond reducing the corporation tax rate, should be undertaken. We look forward to contributing to the debate as it continues.

**Specific Issues**

In response to the specific questions raised, we comment as follows:

**Q1:** This rate depends on an analysis of the economic position, as identified above, with, possibly, consideration of the Laffer curve effect; as far as we are aware the optimal corporation tax rate to balance economic growth and sustainable tax revenues has never, rather frustratingly perhaps, been determined. It is also a fiscal decision, to be made responsibly, based on affordability, in the view of the prevailing economic conditions and after consideration of the extent of the Scottish tax base, and extent of borrowing powers, as discussed above and as established in the Discussion Paper. Concerns also arise about the consequences of the reactions from other European states or the US, in terms of the other economic pressures that might be applied were the tax rate adopted to be regarded as aggressively low (as for the Irish Republic). Accordingly, any responses to this question made without this – or equivalent – argument are made emotionally or instinctively. We have not received any comments from members that it should be lower than the rate currently paid by over 90% of the companies in Scotland, the UK small profits rate of, currently, 20%.

**Q2:** There is some support for maintaining some limited differential for small businesses, but without resolving the issue that the existing small profits rate of corporation tax (as recently renamed) supports businesses of any size but with small profits, rather than small businesses. It is a misconception that this is actually targeted at small businesses; the benefit may be felt by many more. Any tax rate benefit for smaller companies would also give rise to the concerns expressed in our paper at Appendix 1, final point 3 (relating to the UK experience 2000-2005); that the small businesses who benefit from the lower corporation tax rate are primarily sole traders or partnerships paying income tax at perhaps 40-50% deciding to incorporate to save tax,
rather than new entrepreneurial start ups. It is also relevant in this context to consider the tax yield contributed by large companies operating in Scotland. The Oxford University Centre for Business Taxation report cited in the Discussion Paper also suggested particular concentration in the tax base, with a suggested 81% of corporation tax receipts arising from around 1% of the tax base. If the desire is to increase the tax take, and 81% does come from large entities, this might argue against targeting any incentive at the smaller end but favour larger businesses – but with the volatility risk of receipts and a significant introductory cost of a rate cut. It may also be that small businesses are less mobile than larger businesses in their business location decisions.

Q3: A tax system to provide greater support for investment – through capital allowances or similar – for some of the successful, capital based Scottish industries would be welcomed by some members. The key to such reliefs being cost effective is that they target capital spend that might not otherwise be funded and for businesses with funding needs; a wider sectoral review or consultation is needed to identify what these might be. The proposals to continue to favour Research and Development expenditure are supported and we have contributed to the recent HM Treasury and HM Revenue & Customs Consultation Documents in relation to improvements to the Research and Development Tax Credits system and on the introduction of a Patent Box regime.

Q4: The additional growth created by Enterprise Zones is treated with some scepticism by some of our members, as reflected in the Discussion Paper, with the concern being that Enterprise Zones move rather than creates growth. The benefit is often one of timing only rather than an absolute improvement in the rate of return from the investment. It was also observed that care needs to be taken in drafting to avoid Enterprise Zone investment being used as a tax shelter by those with money to invest, rather than achieving real economic value. When considering the competitiveness of the economy, consideration might be given to comparisons of the relative attractiveness of the new Zones in England before deciding the cost and benefit of any tax support given.

Q5: Two perspectives on administration and administrative costs arise; firstly that of the costs to the Scottish Government of establishing and running a tax administration, and secondly that of costs to taxpayers. Any additional administrative burden for taxpayers from a separately administered tax system is undesirable and, in the views of members, could be considerable. It would be the case regardless of whether a tax rate reduction was introduced; it would come about from the separation of the corporation tax systems. The taxpayers’ administrative issues have three main elements:

1. Compliance obligations with existing return requirements which would be split over potentially 2 or more tax authorities. Whilst responsible businesses will meet their compliance obligations, in whichever jurisdiction they operate, the tax administrative burden is recognised as an element of setting up or remaining in any country and as an element of its competitiveness. The Institute of Directors policy paper “How Competitive is the UK Tax System”, published in October 2010 covered these issues. Our members indicate a strong preference for a unified approach, one
corporate return form with separate parts for separate parts of the UK, particularly by larger businesses operating across the UK who will bear the brunt of this additional burden. Our experience of working with HMRC through the Carter Agent Steering Group on the introduction of new IT projects to support the UK tax system evidenced the difficulties and challenges from the establishment of new IT and operating systems in relation to efficient and cost effective tax management. Our recent discussions with HMRC officials have also made clear the considerable pressure on resources, staffing and IT projects within the operational system at present. We have not been without criticism of those HMRC systems, and are regular contributors and participators in discussion about such developments but question whether the investment in building and operating a new, separate regime would be either timely or cost effective for any government at present. Much more detailed evidence and discussions are needed on this decision, pending which the preference for a unified approach, as above, must prevail.

2. Additional requirements will arise from Scotland and any other devolved parts of the UK being regarded as overseas jurisdictions, for transfer pricing purposes. We note at page 44 of the Discussion Paper that the effective use of existing transfer pricing and related rules would act against profit shifting behaviours, yet the burden of complying with those rules is considerable. At present, the Discussion Paper suggests 93% of Scottish businesses are small companies, so under current tax legislation, are exempted from the compliance burden of these rules. Medium sized companies have restricted obligations. The clear implication from the Discussion Papers is that small and medium sized companies would have to meet this burden under a devolved corporation tax system, to provide this fiscal protection, but the Discussion Paper does not elaborate on how, or by what means, the tax base safeguards can be implemented without a significant additional administrative burden.

3. In addition, any businesses with Scottish operations, wherever based, would have to agree with tax authorities, which companies, or branches or permanent establishments were within the tax base, and whether they would be tax resident in Scotland or elsewhere in the UK in order to determine liability under each regime. This would be an additional burden on businesses. At present, HMRC tax residence enquiries are generally complex and lengthy and require significant business and advisory resource to resolve. These issues are surmountable but would not be negligible. It is far from clear whether, or how, this element of cost has been taken into account in the impact and costing assumptions, but it could be considerable.

Finally, it would be informative to consider any precedents for a single revenue agency administering or collecting tax on behalf of two competing jurisdictions, when such an arrangement would seem to create a conflict of interest.
Appendix 1

The Institute of Chartered Accountants of Scotland welcomes the opportunity to comment on the issues around devolving corporation tax to Northern Ireland, given the consequences to corporation tax law as it will affect the rest of the UK and the parallel debate over devolving corporation tax powers to the Scottish Parliament. The views expressed below represent those of members of the Institute consulted in recent years over Scottish tax devolution issues, updated by those from several tax committees comprised of members with considerable experience on corporate and cross border business tax issues.

The concerns we have in respect of devolving corporate tax powers to Northern Ireland are the same as those for Scotland, which were included in the final report from the Calman Commission published on 15 June 2009 as “Serving Scotland Better: Scotland and the United Kingdom in the 21st century (Final Report)”. Specifically, the evidence provided in that report and which remain as current concerns may be summarised as:

1) The potential for divergent rates of corporation tax across the UK to create economic inefficiencies as firms react to considerations other than commercial factors, and indeed harmful rather than efficient tax competition.

2) Evidence that a cut in Scottish corporation tax would attract more profit shifting behaviours than create real economic activity. This is an increasing issue in the electronic age and with video conferencing. The application of anti-avoidance provisions relating to profit shifting would have to be widened to deal with this, adding unwelcome administrative complexity for all UK businesses, not just those in the specific devolved jurisdiction.

3) The potentially significant additional administrative burden and tax compliance costs for companies throughout the UK and HMRC from changes necessary to monitor profit-shifting through, for example, transfer pricing legislation. In particular the exemption currently enjoyed by many small and medium sized enterprises would need to be reconsidered if devolved corporation tax powers are to be effective in achieving their aims, given the predominate business profiles in each jurisdiction, even if the devolved corporation tax rates do not vary significantly from the main UK rate. Determining tax residence of companies, branches and permanent establishments would also create additional burdens.

4) The case for substantive reduction in the possible rate of corporation tax for Scotland was considered to be limited in the short term if the level of public services were to be maintained, at least until or unless Scottish Parliament revenues could be raised from other sources. However, the risk if more than one jurisdiction within the UK has corporation tax varying powers, of a “race to the bottom” is likely to be counter-productive.

5) A key driver to devolution of tax powers was the accountability of the Scottish
Parliament; this was thought to be better achieved through devolving powers on taxes other than corporation tax, particularly those with a closer connection to the electorate.

6) The volatility of corporation tax receipts on a localised basis rather than from the UK economy as a whole was a concern, given that European Union state aid rules do not permit any shortfall to be subsidised by the UK government in such circumstances.

We see no case for considering the Northern Ireland tax issues as sufficiently distinct from those of Scotland to reach a different conclusion, particularly around tax competition and complexity.

There are other key aspects of tax policy making in the UK which are relevant considerations.

1) Firstly, the principle of aiming for stability and certainty in tax matters at a UK level has been greatly welcomed as a means of making the UK as a whole more competitive on the international stage. Any devolution of corporation tax powers to different parts of the UK would reduce stability and certainty, so could reduce the attractiveness of the UK as a whole as well as the particular jurisdiction. This could make any changes counterproductive.

2) Simplification of the tax legislation and the practical operation of the UK’s self-assessment regime have been called for consistently and we support the Government doing more in this area. Devolving corporation tax powers will require additional efforts from businesses and their advisers working across the UK achieves less, rather than more, simplification.

3) In considering the potential for a reduced corporation tax rate of 12.5% for Northern Ireland (or any rate materially lower than an income tax rate) the behavioural consequence of unincorporated businesses seeking to incorporate to take advantage of this rate needs to be considered, along with any evidence that it would stimulate economic activity on a standalone basis. The UK experience of the years 2000 to 2005 with a 10% and then 0% corporation tax rate gave a marked demonstration of this and resulted in an overall reduction in tax payable on those earnings; we have not seen any evidence that additional economic activity resulted from that approach, hence the lower rates were abolished in 2006.

Finally, evidence from members raises serious concerns as to the impact on HMRC resources, and whether HMRC would be able to cope with either the changes required or implementation of such devolved powers at any stage in the current spending round. We have expressed in the past concerns over delays and service levels at HMRC, which were also addressed by House of Commons Committee earlier this year. Any additional resources required will have to be costed fully, should any devolved power be required to meet such costs. There may be both fixed costs, which will be presumably
incurred up front, when the expected revenue generation will be undetermined, and variable costs of operating increased legislative burdens in, as suggested above, areas such as transfer pricing.

We look forward to the outcome of the consultation process.

The Institute of Chartered Accountants of Scotland
8 September 2011