

The Scottish rates of income tax

(Lecture P1086 – 16.14 minutes)

Introduction

When the new devolved Scottish Parliament was set up in 1999, it was given the power to set different income tax rates to those which would apply in the rest of the UK.

Following the Scotland Act 2016, the Scottish Parliament now has full control over income tax rates and bands via the Scottish Rate of Income Tax (SRIT). The Scottish Government has power to vary the basic rate, higher rate and additional rate of income tax for non-savings income. The SRIT rates accordingly apply to non-savings income only – i.e., employment income, rental income, certain trust income and pension income. They do not apply to savings and dividend income.

The Scottish Parliament has no power to or alter, create or abolish income tax reliefs or change the personal allowance (these remains reserved by the UK Government).

Tax receipts from the SRIT are collected by HMRC and paid to the Scottish Government.

Definition of a Scottish Taxpayer

Scottish rates are paid by “Scottish Taxpayers”.

Only individuals can be Scottish Taxpayers so the rules do not extend to trusts or estates in administration, all of whose income will continue to be taxed at UK rates.

To be a Scottish taxpayer, an individual must be resident in the UK for tax purposes. An individual who is non-UK resident cannot be a Scottish Taxpayer. Non-UK residents who pay income tax on UK source income will therefore pay at the normal UK rates (even if they are domiciled in Scotland or the income arises from a Scottish source).

A UK resident individual will be a Scottish taxpayer for a tax year if they have a “close connection” to Scotland. “Close connection” is determined by one’s “place of residence”. An individual has a close connection to Scotland if:

- They have one single place of residence which is in Scotland; or
- They have more than one place of residence in the UK but their ‘main place of residence’ is in Scotland.

A place of residence means a place used by the individual with a sufficient degree of regularity and permanence that would lead a reasonable onlooker, with knowledge of the material facts, to consider that to be the place in which that person habitually lives. This definition bears a similarity to that used by HMRC in the “home” test of the SRT. So in other words, one’s main place of residence is one’s “home”.

This means that an English person living in Dumfries but working in Carlisle would be a Scottish Taxpayer whereas a Scottish person living in Northumberland but working in Edinburgh would not.

That residence does not have to be owned by the individual. A property which is let (and not available to use) cannot be a place of residence. Neither is a holiday home which is used occasionally.

If an individual changes residences part way through the tax year, his close connection will be determined as a question of fact typically by looking at the time he has spent during the tax year at each of those residences. So, an individual living in England who then moved to Glasgow in July 2018 would have spent more time at his Scottish residence in 2018/19 than his English one. He would therefore be a Scottish Taxpayer in 2018/19. There is no provision for the Scottish rates to apply for part of a tax year. [Although PAYE could already have been applied in the early part of the year at the UK rates thereby leading to a potentially under/over payment at the year-end.]

An individual must tell HMRC if they move address to or from Scotland. In this case the new rate will be backdated to the start of the tax year in which they moved.

Where a taxpayer has two residences in the UK at the same time and one is in Scotland, the main place of residence is determined as a question of fact. There is no election. The main place of residence is the place with which the individual has the greatest degree of connection. This may not always be the residence where the individual spends most of their time.

Factors to consider in determining the main place of residence include (but are not limited to):

- The place where the individual's family (spouses, children etc) spend their time;
- Where the children go to school;
- The address used for main correspondence;
- Where most of the individual's possessions are kept;
- The place which is the centre of the individual's social life;
- The place the individual is registered to vote / has a doctor or dentist etc.

For example, assume that Kevin has a house in Glasgow but works in Manchester. He rents a flat in Manchester and works in Manchester from Monday to Thursday. On Thursday night he gets the train back to Glasgow, works at home on Friday, spends the weekend in Glasgow then gets the train back to Manchester on Sunday night. His wife and family live in Glasgow and the children go to school in Glasgow. He is registered to vote in Glasgow.

In this case even though Kevin spends more than half his week in England, his main place of residence will be in Scotland so he will be a Scottish Taxpayer.

If a UK resident individual does not have a place of residence (which is unusual), to determine whether he is a Scottish Taxpayer we compare the amount of days spent in Scotland to the amount of days spent in other parts of the UK. The 'midnight rule' applies when counting days.

Scottish Members of Parliament (or Members of the European Parliament representing a Scottish constituency) are always Scottish Taxpayers regardless of the place of residence rules. The reverse is true of Westminster MPs.

Scottish rates

In 2017/18, the only notable difference between Scotland and the rest of the UK was that the higher rate limit in Scotland was frozen at £31,500 (it was £33,500 for the rest of the UK). Middle earners in Scotland therefore paid slightly more income tax than their English counterparts. The additional rate limit was as for the UK (£150,000).

The position for 2018/19 is far more complicated. There are five Scottish income tax bands in force from 2018/19 onwards (again only applying to non-savings income of Scottish Taxpayers with savings and dividend income remaining taxable at UK rates and bands). These changes are expected to increase the overall tax contribution by Scottish Taxpayers by around £220 million.

These new Scottish bands are:

Name of the tax band	Tax band	Tax rate
Starter rate	£1 - £2,000	19%
Basic rate	£2,001 - £12,150	20%
Intermediate rate	£12,151 - £31,580	21%
Higher rate	£31,581 - £150,000	41%
Top rate	> £150,000	46%

The income tax higher rate threshold for Scottish Taxpayers (after personal allowances) will therefore be £43,430 in 2018/19 (compared to the UK higher rate threshold of £46,350).

The Scottish Government's calculations indicate that individuals with taxable income (above the personal allowance) under £33,000 will pay less income tax in 2018/19 than they did in 2017/18. 30% of Scottish Taxpayers will pay more income tax in 2018/19 than they did in 2017/18.

Due to a combination of higher tax rates and a lower basic rate threshold, taxpayers with total income of over £26,000 in 2018/19 will pay more tax if they live in Scotland than elsewhere in the UK. Very low earners will benefit.

All payrolls must operate the Scottish rates of income tax for Scottish Taxpayers, regardless of where the employer is based. This means that an English business would have to apply Scottish rates to an employee who lives in Scotland. HMRC issue PAYE codes with an 'S' suffix for individuals believed to be Scottish taxpayers. The PAYE system has been amended to incorporate new tax codes for Scottish Taxpayers, such as extra 'D' codes (SD0, SD1, SD2 etc.) to reflect the new five-band system.

The online SA return contains a tick-box for taxpayers to notify HMRC if they will pay tax at Scottish rates.

Mismatches for Scottish Taxpayers

There are a number of mismatches for Scottish Taxpayers in relation to their counterparts in other parts of the UK.

Interest income and dividend income:

The income tax rates and thresholds for interest and dividend income of Scottish Taxpayers are the same as for taxpayers in the rest of the UK. This means that the starting rate for savings, the savings nil rate band and the dividend nil rate band are all available for Scottish Taxpayers. Scottish Taxpayers could therefore be higher rate taxpayers for non-savings income (at Scottish rates) but basic rate taxpayers for savings income (at UK rates).

The UK tax bands will apply to determine the amount of the savings nil rate band. For example, Scottish Taxpayers with total taxable income, after the personal allowance, of (say) £34,000, would be a Scottish higher rate taxpayer but a UK basic rate taxpayer, so the savings nil rate band (based as it is on UK rates) would be £1,000.

Benefits

If benefits are taxed on a “grossed-up” basis (either via a Taxed Award system, or under a PAYE Settlement Agreement or a tax equalisation agreement), the employer will need to consider the marginal rate of the relevant employees to ensure the amount of the benefit is grossed-up correctly. The five-band structure makes these calculations potentially very complex.

Trust income

Some trusts are opaque (e.g., discretionary trusts) while others are transparent (e.g., IIP trusts, bare trusts and settlor-interested trusts).

Income from opaque trusts is treated as non-savings income and will therefore be fully taxed at the Scottish rates.

Income from transparent trusts retains its character in the hands of the beneficiaries. So non-savings income received from (say) an IIP trust would be taxed at Scottish rates whilst savings and dividend income from the trust would be taxed at UK rates. The same applies to income distributions from estates in administration. This could mean that a single income distribution from an estate could be taxed at 9 different rates – 4 Scottish rates and 5 UK rates. Someone should tell the Office of Tax Simplification.

Income distributions should be certified by the Trustees on the form R185 given to the beneficiary and Trustees should ensure that the income is properly and correctly separated.

Partnership / LLP income

Under tax law, a partnership itself is not taxed on its profits. Instead the individual partners are taxed on their share of the partnership income. The same is true of LLPs.

Partnership / LLP income is non-savings income so the allocated partnership profits of Scottish Taxpayers will be taxable at Scottish rates of income tax. The fact that a partnership is a legal entity in Scotland but not in England is irrelevant here.

This means that a partner who lives in Scotland will pay income tax at different rates to his/her English partners. Remember that the rates are determined by the main residence of the partner (not the business address of the partnership).

Capital gains tax

The CGT rate depends on the remaining basic rate band for income tax. As CGT is reserved by the UK Government, the higher rate threshold for CGT for Scottish Taxpayers continues to be aligned with the higher rate threshold for the rest of the UK. Therefore, it is possible to be a higher rate taxpayer in Scotland but to still have some basic rate band remaining for the purposes of calculating CGT.

Class 1 and Class 4 NICs

NICs are not devolved. The upper earnings limit for Class 1 and the upper profits limit for Class 4 are therefore aligned with the higher rate threshold that applies in the rest of the UK. Therefore, employed Scottish Taxpayers will face a marginal rate of 53% on earnings between £43,431 and £46,350 (being the Scottish higher rate of 41% plus the Class 1 primary rate of 12%). The marginal rate for the self-employed at this profits level will be 50% (being the Scottish higher rate of 41% plus the Class 4 main rate of 9%).

Contributions to personal pension schemes

These continue to be paid net of 20% basic rate tax with tax relief given to higher rate taxpayers by extending the basic rate band. The Scottish basic rate remains at 20% in 2018/19, so the relief at source rules should not be affected. However, for Scottish Taxpayers paying tax at a rate above 20%, the relevant tax bands (i.e., the basic rate, intermediate rate and higher rate bands) need to be extended by the gross pension contribution. The Scottish starter rate (19%) is not extended as this rate is lower than the Scottish basic rate.

As Scottish rates only apply to non-savings income, the UK basic rate threshold may also need to be extended to determine the rates which apply to savings and dividend income.

Scottish Taxpayers earning over £24,000 (personal allowance £11,850 plus basic rate band £12,150) will need to claim any extra relief to which they are entitled either via their SA return, their Personal Tax Account, or by telephone or post. For those in the intermediate rate (21%) band, this will mean claiming an extra 1% tax relief (which many might not bother with).

Donations to charity under Gift Aid

These are deemed to be paid net of 20% basic rate tax, with higher rate relief given by extending the basic rate band (and in the case of Scottish Taxpayers, the intermediate rate and higher rate bands). This will mean that unless the Scottish donor is a basic rate taxpayer (with taxable income falling into a narrow band between £2,000 and £12,150), the relief at source will not match the relief entitlement.

Where the taxpayer has not paid sufficient tax to cover the relief at source, this is collected via a tax charge under Self-Assessment. This has the unfortunate consequence that Scottish Taxpayers paying tax at the starter rate of 19% who make Gift Aid donations may find themselves needing to complete a Tax Return to pay over the 1% difference! It is hoped that HMRC would take a common-sense view on this in view of the amounts involved.

As with personal pension contributions, anyone paying tax at a rate above 20% will need to extend the relevant tax bands to obtain marginal rate relief thereby increasing the number of people who will need to complete a Tax Return. Again, many in the intermediate band will simply not bother.

The Transferrable Marriage Allowance

Where the necessary conditions are met, the Marriage Allowance allows taxpayers to transfer 10% of their personal allowance to their spouse/civil partner, who then receives a tax reduction equal to 20% of the transferred amount.

The Marriage Allowance is not available to non-Scottish taxpayers where either partner pays tax at a rate other than the basic rate (or the dividend ordinary rate).

However, for Scottish taxpayers, an election for the Marriage Allowance can still be made where one of the partners pays tax at the intermediate rate of 21% (as well as the starter rate of 19% and the basic rate of 20%).

Setting-off reliefs

A Scottish Taxpayer is likely to have income subject to various different rates of tax. Where a taxpayer is entitled to claim a relief by way of a deduction against income, he can choose the relief method that results in the highest reduction of tax.

Although Scottish Taxpayers now have more bands – and by definition more choice – the principle remains unaltered and a claim for relief against income subject to a 21% Scottish rate will be more beneficial than a deduction against income liable to a 20% UK rate.

Conclusions

The five-tier structure of rate bands seems to have been designed by the Scottish Government such that it can be easily manipulated in future to make the regime more progressive (for example by increasing the Starter Rate band at the expense of squeezing the basic, intermediate or higher rate bands). It could also signal a move to increase higher tax rates in small increments (although unsurprisingly this has not been either stated as a policy or ruled-out).

From a Scottish Taxpayer's perspective, an extra tax burden has been placed on the shoulders of higher earners, but at the moment this is pitched at a level which the politicians in Scotland believe is unlikely to trigger significant behavioural changes such as incorporation or emigration (either to England or elsewhere). It might however affect the decision of overseas assignees to the UK who – if they are a higher earner who is not tax equalised – may decide against living and working in Scotland. It could also have an effect on the recruitment of well-paid workers.

What is certain is that tax practitioners will find their Scottish clients' income tax increasingly difficult to deal with and those who companies which produce our tax software will have some nasty programming headaches to look forward to. Checking these calculations by hand before advising Scottish clients of their liabilities (and checking any sent to us by HMRC who have a habit of taking at least a year to get these things right) will be recommended.

Contributed by Steve Sanders