Income Tax and the Scottish Budget

Her Majesty's Revenue and Customs (HMRC) has been issuing letters to those that it considers (based on its records) to be Scottish taxpayers. This is a residence-based decision, and taxpayers are being invited to contact HMRC if they think that its conclusion is incorrect.

The reason for this activity is that, for the 2016/17 tax year, the Scottish Parliament has the opportunity, under the Scotland Act 2012, to set a Scottish rate of income tax (SRIT). The 2012 Act effectively reduces UK income tax rates by ten percentage points, and allows the Scottish Parliament to set a single Scottish rate, which can be more or less than (or indeed equal to) ten per cent. On 16 December 2015, John Swinney, the Scottish Government's Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy, announced that he plans to set the SRIT at ten per cent for 2016/17, with the result that income tax rates in Scotland will remain the same as for the rest of the UK.

The explanation given for this (ostensibly anti-climactic) decision refers to the 'inflexible nature' of the Scotland Act 2012 power. It allows the Scottish Parliament to set a single SRIT that will be added to the UK rates (which, as noted above, will have ten percentage points deducted from them). That means that the overall rates experienced (suffered) by Scottish taxpayers could only be increased or reduced by the same number, across the board. So, for example, if the Scottish Parliament was to set the SRIT at eleven per cent, the marginal tax rate payable by Scottish basic rate taxpayers would become 21 per cent (versus 20 per cent elsewhere in the UK), the higher rate would become 41 (as opposed to 40) per cent, and the additional rate 46 (rather than 45) per cent.

Under the Scotland Bill that is currently making its way through the UK Parliament, the Scottish Parliament would gain much more discretion over the income tax paid by Scottish taxpayers. It would be able to vary both the individual tax rates and the earnings thresholds at which each rate applies (although the personal allowance, the taxation of savings and dividend income, tax reliefs and the definition of income would remain under the control of the UK Parliament). The new powers could be available for the 2017/18 tax year.

Implications for pension schemes

The Scottish Government's announcement should mean that there are few implications for pension schemes in the short term. In the longer term, the SRIT should not involve significant changes for most occupational pension schemes. Contribution tax relief for employers would be unchanged whilst for individuals tax relief would continue to be received automatically at the correct rate through 'net pay arrangements'.

Things would be more complicated for those schemes (typically contract-based arrangements) that use 'relief at source' for contributions. In such cases the scheme administrator is expected to claim an amount equal to basic rate tax from HMRC, and higher- and additional-rate taxpayers obtain the extra relief due through their self-assessment tax returns. For the first two years of the SRIT, from April 2016, scheme administrators are to be allowed to submit these basic-rate tax claims as if all members are UK taxpayers, with HMRC making any corrections necessary for Scottish taxpayers through self-assessment or their PAYE codes. From 2018, however, providers' systems will have to be capable of identifying Scottish taxpayers (based on information provided by HMRC) and making claims at the Scottish basic rate.

Regardless of the type of scheme, new S-prefixed PAYE codes for Scottish taxpayers should ensure that tax at the correct rate is deducted from earnings and pensions. Employers, trustees and administrators should confirm that their payroll software is or will be up to the task.