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Scottish income tax control threatens big trouble across UK

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Oil workers are among those whose tax bills could get complicated. Mike Paskin, CC BY-SA

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The UK tax system is about to experience one of its biggest ever upheavals. From April 2016, there could be two tax jurisdictions for income tax for the first time.

We can't definitively say what will happen yet, because the current Scotland Bill is still subject to negotiation – and is due to head back to the House of Commons in the coming days. But the Scottish government will probably have powers to set thresholds and rates for income tax and keep all income tax revenues raised in Scotland.

You would be wrong to think of this as purely a Scottish matter, however. It will affect people, companies and organisations across the UK, not to mention the two governments. If we don't get the legislation right, it could open up a world of trouble and complexity.

Residency problems

The first big issue will be to determine who is taxable in Scotland and who is taxable in the rest of the UK. While tax residency will be easy to determine for most people, it will be more difficult for others. Difficult examples might include North Sea oil workers; travelling sales representatives; people working in the trades, particularly in the border regions; financial services people based in Edinburgh and London; and staff seconded to long-term projects, such as computer systems development.

According to the Scotland Act (2012), a Scottish taxpayer is an individual who is resident in the UK for income tax with a "close connection" with Scotland. The act defines a "close connection" as having a place of residence in Scotland and living there for part of the tax year in question, or having two or more main places of residence in different parts of the UK and spending an equal or greater time at the residence in Scotland.

It appears that a taxpayer with a "close connection" with one tax jurisdiction would not be taxed in the other jurisdiction. For instance, suppose an IT consultant lives on Skye but has a flat in London, where the consultant is based for four months of the year, spending the rest of the time in Scotland earning nothing. That person would be deemed to be a Scottish taxpayer.

Part-time crofters take note. Stephanie Lamphere, CC BY

The "close connection" rule also opens up a lot of scope for uncertainty Could an oil platform, temporary shared accommodation, short-term let, hotel or bed and breakfast accommodation constitute a "main place of residence"? Assuming an oil platform was not deemed to be such a residence, for example, UK residents working in the North Sea in Scottish waters who have a "close connection" with the rest of the UK would not be treated as Scottish taxpayers.

And even if an oil platform could be a main place of residence, it would become a question of where the person spent more days, which is open to abuse. How accurate would people's records be of the time they spend in each tax jurisdiction? Would people be tempted to falsify their records – this is tax evasion – to gain a tax advantage?

No wonder the Devolution (Further Powers) Committee recently said "there were significant issues still to be resolved regarding the implementation of the new powers, such as an appropriate definition of residency for a Scottish taxpayer". (Speaking of parliament, the position is ironically clear for one group of people: MSPs, Scottish MPs and Scottish MEPs. They will be Scottish taxpayers no matter where their main place of residence is.) More thought based on real-life examples is required to produce a practical, politically acceptable definition. And it must be done as soon as possible.

All companies and organisations on both sides of the border will also have to maintain payroll systems capable of meeting the current and future requirements of both tax jurisdictions – like different thresholds, more thresholds and different tax rates – and ensure that tax revenues are directed to the right government. Hopefully software engineers will make the necessary modifications to payroll systems in the next few months, since the two UK systems could diverge as soon as next year.

To raise taxes or not?

When it comes to the two governments deciding what income tax levels should be, having different tax jurisdictions creates an extra policy dilemma. Despite what they think, the governments don't have freedom of action. They have to think about the wider implications of their policies, particularly because of the integrated nature of the UK economy.

A fact-sheet published in 2014 by the Scottish parliament expected some taxpayers to relocate to the more favourable UK tax jurisdiction if the two tax regimes diverge, acknowledging that "additional rate taxpayers react the most to changes in tax rates". Some may even be tempted to do a paper relocation, which is tax evasion, but may be difficult to prove in practice.

This raises the potential for significant chunks of tax revenue to switch jurisdictions, as the HMRC income-tax figures for 2014/15 in the following table show:

	Percentage of Income Tax Raised From Each Taxpayer Group
Bottom 50%	9.8%
Top 50%	90.2%
Top 25%	74.9%

Top 10%	58.3%
Top 5%	47.2%
Top 1%	27.3%

HMRC

And in the UK this issue is probably of even greater concern since it is not just the very high earners who are in a position to take action in relation to their tax affairs, due to the prevalence of cross-border working by lower earners.

Income tax has long been considered a toxic way of increasing taxes at UK level, so the policy dilemma will initially rest with Scotland, whose SNP government's general election manifesto contained a commitment for a 50% tax rate. Will it be implemented when the new tax powers become law in view of the potential economic consequences? Time will tell.

Taxation **Scotland** **Treasury** **Devolution** **Income tax** **Holyrood** **Scottish Government** **Smith Commission** **HMRC**