FOURTH ANNUAL REPORT ON THE IMPLEMENTATION AND OPERATION OF PART 3 (FINANCIAL PROVISIONS) OF THE SCOTLAND ACT 2012

Fourth Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012

Presented to Parliament pursuant to Section 33(1)(b) of the Scotland Act 2012

Presented to the Scottish Parliament pursuant to Section 33(1)(c) of the Scotland Act 2012

March 2016

SG/2016/26

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at enquiries@scotlandoffice.gsi.gov.uk

Print ISBN 9781474130196
Web ISBN 9781474130202

ID P002796918 55122 03/16

Printed on paper containing 75% recycled fibre content minimum

Printed in the UK by the Williams Lea Group on behalf of the Controller of Her Majesty's Stationery Office

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FOREWORD

This fourth Annual Report marks significant milestones in the implementation of the Scotland Act 2012. Since the publication of last year's report, we have seen the successful commencement of the Land and Buildings Transaction Tax and Scottish Landfill Tax – the first new Scottish taxes in over 300 years. The Scottish Rate of Income Tax will take effect in April 2016, with the Deputy First Minister having announced in December that he intends to retain the same level of income tax as the rest of the UK for 2016/17.

The successful delivery of these programmes, on time and on budget, is testament to the cross-government working between UK and Scottish Government Ministers and officials for the benefit of people in Scotland. This collaborative working was recognised by the National Audit Office in last November's report on *The Administration of the Scottish Rate of Income Tax*, which noted the sound governance process in place and the proactive engagement between HMRC and the Scottish Government.

The implementation of the Scotland Act 2012 is of course just one element of the transfer of new powers to Scotland which has taken place in the past year. The Scotland Bill, introduced to Parliament on 28 May 2015, fulfils the Government's manifesto commitment to implement in full the all-party Smith Commission Agreement. It also brings a better balance to Scotland's devolution settlement and strengthens the Union as a result.

Major new powers on taxation, welfare and a range of other matters, added to the powers the Parliament already has, will see the Scottish Parliament become one of the most powerful and accountable devolved parliaments in the world. The scale of these new responsibilities and opportunities mean that the Scottish Parliament elected in May will be a very different Parliament to its predecessors. It will, in effect, be a new Scottish Parliament: Holyrood 2.0.

The Scottish Parliament was created with extensive powers over public spending - today it is responsible for almost 60% of Scottish public spending - but with little responsibility for raising the funds it spends. With the devolution of around £12 billion of income tax powers, the assignment of around £4.5 billion of VAT revenues per year, and around £2.7 billion of welfare, the Scotland Bill will build on the Scotland Act 2012 to increase the financial accountability of the Scottish Parliament to people in Scotland.

With the Bill expected to conclude its Parliamentary passage shortly and a fiscal framework agreed between the UK and Scottish Governments, the focus now turns to the implementation of these powers. I am confident that the UK and Scottish Governments will build on the experiences of the Scotland Act 2012 to deliver timely and successful implementation of the new powers.

The issue that is now for debate is how these powers will be used. There are huge opportunities ahead for Holyrood and I look forward to the parties in the Scottish Parliament setting how they will respond to these.

Rt Hon DAVID MUNDELL MP
SECRETARY OF STATE FOR SCOTLAND

CHAPTER 1

INTRODUCTION

Scope and Content of this Report

1. This report on Part 3 of the Scotland Act 2012 is the fourth published since the Act gained Royal Assent on 1 May 2012.

2. Part 3 of the Scotland Act 2012 deals exclusively with the devolution of financial powers. These include:
    - the creation of a new Scottish rate of Income Tax;
    - the disapplication of UK Stamp Duty Land Tax in Scotland and provision for the introduction of a new Scottish tax on land transactions;
    - the disapplication of UK Landfill Tax in Scotland and provision for the introduction of a new Scottish tax on disposals to landfill;
    - provision for borrowing by Scottish Ministers; and
    - the power to create new devolved taxes.

3. The financial provisions will be implemented over a number of years, in line with the timetable set out in the Command Paper which accompanied the publication of the Scotland Bill in November 2010, to ensure that appropriate transitional arrangements are put in place. In order that both the UK and Scottish Parliaments are fully informed through this process, section 33 of the Scotland Act 2012 requires the Secretary of State for Scotland and Scottish Ministers to report annually on the implementation of this part of the Act.

4. Both Parliaments will be sighted on the views of both administrations: the Secretary of State for Scotland is required to report to the UK Parliament and provide a copy to Scottish Ministers who are required to lay it before the Scottish Parliament; and Scottish Ministers are required to report to the Scottish Parliament and provide a copy to the Secretary of State, who is required to lay it before both Houses of Parliament at Westminster. Both Governments will continue to report until April 2020, or the first anniversary of

the day on which the last provisions of Part 3 come into force, if that is after April 2020.

5. Section 33(5) of the Scotland Act 2012 requires the annual reports to contain:
   (a) a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,

   (b) a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,

   (c) an assessment of the operation of the provisions of this Part which have been commenced,

   (d) an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,

   (e) the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund), and

   (f) *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

6. *Annex A* provides a detailed list of the paragraphs in the report which address each of these requirements. However, the report is not limited to these requirements, and can also contain any other matters that each Government believes to be relevant or useful to both parliaments.

CHAPTER 2

SCOTLAND ACT 2012 IMPLEMENTATION PROGRAMME

Implementation of the Scottish rate of Income Tax and disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland is delivered by HMRC through separate projects with oversight and governance provided by HMRC's Scotland Act 2012 implementation programme. The programme board includes representatives from HMRC, HM Treasury, the Scotland Office and the Scottish Government. Programme board members are involved in decision making to ensure that the projects deliver effective solutions and value for money.

Steps taken towards implementation since previous report

7. The projects to deliver disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland were formally closed in the autumn of 2015 following the successful transition to the Land and Buildings Transaction Tax and Scottish Landfill Tax on 1 April 2015. HMRC has continued to work closely with the Scottish Government to manage implementation of the necessary system and process changes required to introduce the Scottish rate of Income Tax from 6th April 2016 and to deliver a comprehensive communications strategy to support implementation.

8. The Statement of Funding Policy sets out the principle that the devolved administrations will meet all the operational and capital costs associated with devolution from within their allocated budgets. Information about the costs passed onto the Scottish Government as a result of the programme and individual projects is provided in the relevant sections of this report. Additionally, the UK Government committed to transferring to the Scottish Government the costs saved by HMRC from no longer operating Stamp Duty Land Tax (SDLT) and Landfill Tax in Scotland. The net amount of the annual saving is £257,000 and this amount was transferred from HMRC to the Scottish Government in the 2015-16 Main Estimates.

9. Edward Troup (HMRC's Tax Assurance Commissioner and Additional Accounting Officer for the Scottish rate of Income Tax) and Sarah Walker (Deputy Director and Head of HMRC's Devolution Team appeared before the Scottish Parliament's Finance Committee in October 2015 and Sarah Walker appeared before the Public Audit Committee in January 2016 to report HMRC's progress on implementing the Scotland Act 2012.

10. HMRC was represented on Revenue Scotland's tax administration programme board, contributing to Revenue Scotland's development of systems to manage the devolved taxes. That programme was formally closed in May 2015.

11. Progress on the individual projects to implement the Scottish rate of Income Tax and disapply SDLT and Landfill Tax is covered in greater detail in chapters 3, 4 and 5 of this report.

Further steps that will be taken towards implementation

12. In 2016-17, the programme will continue to provide oversight of the Scottish rate of Income Tax project, including implementation of the next phase of IT changes to the PAYE and Self- Assessment systems, and work to develop detailed specifications for changes to the Relief at Source (RAS) process for receiving pensions tax relief. The Board will meet regularly to consider progress towards implementation. HMRC has shared with the Scottish Government an estimate of approximately £10m for its work in 2016-17, comprising £8.5m to implement the programme and project and £1.5m running costs.

CHAPTER 3

SCOTTISH RATE OF INCOME TAX

From April 2016, the main UK rates of Income Tax will be reduced by 10 pence in the pound for those identified as Scottish taxpayers. The Scottish Parliament will set, in its annual budget, the new Scottish rate of Income Tax to be added to the reduced UK rates. The Scottish block grant will be adjusted to reflect this change in funding streams. Implementation of the Scottish rate is led by a HMRC project with representatives on the project board from HM Treasury, Scotland Office and the Scottish Government.

Steps taken towards implementation since previous report

13. During 2015-16, HMRC has been focussing on the final stages of implementation ahead of the introduction of the Scottish rate of Income Tax on 6 April 2016. This has centred on working with its IT supplier to make the necessary changes to its systems, contacting Scottish taxpayers and employers to advise them of the introduction of the Scottish rate and let them know what they need to do and developing wider communications and compliance plans.

14. As set out in the 2015 report, HMRC has been taking a phased approach to its IT development for the Scottish rate. The first phase was launched successfully in October – this allows HMRC to identify Scottish taxpayers separately on its systems. A further phase will be implemented in April, which will put in place the necessary PAYE changes, with additional phases to follow looking at changes to the Self Assessment system and the Relief at Source (RAS) process for claiming tax relief for pension contributions.

15. HMRC has also greatly increased its communications activity relating to the Scottish rate in 2015-16. HMRC has written to all taxpayers for whom it holds a Scottish address on its systems – 2,453,763 letters were issued in the first two weeks of December. Alongside this, HMRC also wrote to around 2,500

taxpayers for whom they held a Scottish correspondence address, but a residential address elsewhere in the UK, on their systems.

16. As well as this, HMRC carried out a comparison of its address data against the Scottish Electoral Register in order to identify taxpayers who were on the Register but for whom HMRC held an address elsewhere in the UK. This identified a pool of around 14,500 customers, who received a separate letter in January.

17. All the letters advised customers that the Scottish rate was being introduced in April 2016 and that HMRC had identified them as potential Scottish taxpayers. They only needed to take action if HMRC did not hold the correct address for them. Following the issuing of the letters, HMRC received the following contact from customers[1] –

    - Around 144,000 unique web-hits on the Scottish rate related web pages
    - An estimated 11,500 online address updates attributable to the SRIT message.
    - Around 16,000 telephone notifications of address changes estimated to be attributable to SRIT
    - 455 enquiries to HMRC's call centre.

18. Most customers found the letter fairly straightforward and understood that no action was required unless the address details held by HMRC were incorrect.

19. In addition to the letters, the following communication activities have also taken place:

- A range of guidance has been published on GOV.UK, including detailed guidance for customers to determine whether they will be a Scottish taxpayer. HMRC consulted a range of tax professional organisations on the draft of the

[1] During period December 15 – February 16(figures rounded).

detailed guidance, which allowed the guidance to be amended to ensure it was fit for purpose;

- HMRC has worked hard to make its online services easier to use and accessible to all taxpayers. To support those who can't, or prefer not to, use the online facilities, HMRC has worked closely with organisations in Scotland such as Citizens Advice Bureau, Low Incomes Tax Reform Group, libraries, and Age UK, so that they can help customers to access this information. Additionally, all HMRC call centre staff have received training so they can reply to queries about the Scottish rate of income tax.
- The Scottish Government made the text of the Scottish Notification Letter available on its website.
- Detailed specifications have been released to employers and software providers to enable them to update their payroll systems ahead of the introduction of the Scottish rate;
- HMRC representatives have spoken to hundreds of employers, agents, representative bodies and individuals at a large number of events in Scotland and elsewhere in the UK. These have included the annual conference of the Chartered Institute of Payroll Practitioners, tailored events for Scottish public sector organisations and also using an HMRC blog designed for tax agents.
- This was followed with over 500,000 email alerts to those employers, agents and partners registered with HMRC to receive communications via this route, with a higher than industry standard opening rate reported.
- A comprehensive communications strategy has been produced to support the introduction of the Scottish rate. In addition to the points outlined, a media campaign took place during February and March 2016, primarily to target specific customer groups, such as students, taxpayers who live in the borders and also home movers to ensure they are aware of the introduction of the Scottish rate and the implications for them.

20. HMRC has undertaken some preparatory compliance activity to gain a greater understanding of the levels of awareness of, and preparation for SRIT, - and in particular the appetite for people to amend their behaviours in the light of any divergence in rate. This work will continue and is now being used to

inform and finalise a compliance model for the Scottish Rate. The Scottish Government's announcement of a 10% Scottish rate of Income Tax for 2016-17 means that an individual's tax liability will be the same whether or not they are a Scottish taxpayer so HMRC's focus during the first year of operation is expected to be on assurance activity to ensure that it has correctly identified Scottish taxpayers. This will include carrying out further work to check addresses of Scottish taxpayers and may involve bespoke analysis to monitor cross border migration trends and to validate the accuracy of reported moves and also the type of large-scale data comparison exercises undertaken previously. Additionally, HMRC will continue working to raise awareness of the Scottish rate with employers via its employer compliance checks.

21. Further legislation relating to the Scottish rate has also been produced in the last year. An order making consequential changes needed as a result of the Scottish rate, for example in relation to Gift Aid and RAS, was debated in Parliament on 16 September and became law on 20 October. Additionally, the PAYE Regulations, which provide the legislative framework for the PAYE system as a whole, were amended to take account of the Scottish rate and an Appointed Day Order was laid confirming that Scottish rate would be introduced on 6 April 2016.

22. HMRC's work on the Scottish rate has been the subject of external scrutiny during the last year. In May 2015, the Office of Government Commerce (OGC) undertook a Gateway 3 strategic assessment of the project to implement the Scottish rate. This stated that successful delivery of the Project was feasible and identified key areas for the Project to focus on, including identifying Scottish taxpayers and communications. The report also recognised that the project team had embedded a successful approach to collaborative working, which many interviewees commented was exceptional in their experience of project work.

23. Under the Scotland Act 1998, as amended by the Finance Act 2014, the National Audit Office (NAO) is obliged to produce an annual report on HMRC's work on implementing (and, in due course, administering) the

Scottish rate. The first report was published on 26 November – the NAO recognised HMRC's thorough approach to identifying Scottish taxpayers, the sound governance of the implementation project, the clear strategies in place for communications and compliance and the positive response to recommendations in previous OGC reports.

24. In the 2015 (3rd) annual report, DWP indicated that it would be carrying out work on its benefits systems to take account of the creation of the Scottish rate of Income Tax.

25. There are several, mutual interdependencies within the UK tax and social security systems which arise in the implementation of the SRIT. For example, the UK Social Security System, administered by the Department for Work and Pensions (DWP), is responsible for a number of benefits where entitlement is dependent on income net of tax. Furthermore some social security benefits themselves are taxable e.g. Jobseeker's Allowance (JSA) and others non-taxable e.g. Disability Living Allowance (DLA).

26. This correlation was recognised previously in the arrangements made for Scottish Variable Rate (SVR), where the Scottish Government (SG) provided funds to what was then the Department of Social Security (DSS) in order to make preliminary preparations for a Scottish Variable Rate (SVR) as set out in the Scotland Act 1998.

27. Since 1998 there have been many changes to the benefit system and general benefit landscape. DWP set up a Project Team to conduct an extensive review of both IT and non-IT systems to identify the changes required to recognise and interface with SRIT. This included an examination of the earlier changes made in preparation for SVR.

28. During 2015 DWP has worked with its IT suppliers and HMRC to ensure that, where appropriate, all the necessary modifications to the IT systems are carried out and tested to recognise SRIT from April 2016. Internal procedural guidance for DWP staff has also been drawn up.

29. The Office of Government Commerce undertook a Gateway review from 27/10/15 to 29/10/15 of DWP's readiness for service. The review stated the project was set fair for delivery and identified some areas to focus on around internal governance and reporting. The review also recognised that the project was well-run and had won the confidence of its stakeholders.

Costs

30. The 2015 annual report included overall estimated costs for implementing the Scottish rate of Income Tax of £30m-£35m made up of non-IT costs of £20m and IT costs of £10m-£15m (against an original total estimate of £40m-£45m).

31. The 2015 report set out that the bulk of this expenditure (£26m) was expected to take place in 2015-16, largely to pay for direct contact with potential Scottish taxpayers and the associated publicity. Given the unique nature of this exercise, there was a limited amount of evidence to inform this forecast from previous contact exercises, so research was carried out to refine estimates of the likely levels of response from taxpayers. An estimate was included for expenditure on publicity, but decisions on the amount of publicity which would represent value for money were taken in the light of an assessment of the accuracy of HMRC address data and following the customer research. In practice, the cost of the direct contact with customers was significantly lower than the estimate made before the customer research was undertaken. The main reason for this is that the rate of response to the letters was lower than previously anticipated – this was because the letters were designed to reassure recipients that no action was needed unless the address used was incorrect. The announcement of the draft Scottish Government budget, which confirmed that the tax rates in Scotland would be the same as in the rest of the UK, is also likely to have reduced the rate of response to the letters.

32. The forecast at the start of 2015-16 for the cost of sending letters to Scottish taxpayers and dealing with contact from individuals and businesses was £8.9m – the actual cost was £1.9m. The cost of communications and publicity

and associated contact is estimated to be £0.5m against a forecast of £4.2m. HMRC are confident that the combined effect of the targeted mailshot and publicity is enough to give confidence in the accuracy of identification of Scottish taxpayers at a significantly lower level of cost than previously forecast. The project delivery costs have increased from £3.7m to £4.7m because additional project management resource has been brought in to manage the changes needed to implement the application of the Scottish rate to contributions to relief at source pension schemes. The current estimate of total non-IT costs is £8.5m.

33. Further work has also been carried out to refine the estimate of IT costs. The first phase of activity cost £2.9m and a revised estimate for the second phase(which will be delivered in April) is £3.0m.

34. The 2015 annual report included an estimate of £10m for the changes to HMRC's PAYE and Self Assessment systems, with up to an additional £5m for changes to the RAS system. The PAYE and Self Assessment changes are still anticipated to cost £10m, while the changes to the pension relief at source system are now estimated to be in the region of £7m. The change is due to an increase in the estimates of the costs for introducing a system to allow automatic exchange of identification information with pension providers so that they can correctly calculate the tax relief due to Scottish taxpayers. These estimates of the costs of the RAS changes are subject to later revision as the work is still at an early stage, as these will be introduced in 2018. Additional costs of up to £1m are likely to arise to incorporate the Scottish rate within HMRC's digital services for customers, such as the personal tax account, and make other minor changes, for example amending the free PAYE software which HMRC provides for employers.

35. These changes now suggest a total IT cost in the region of £18m but given the potential for further changes to the RAS costs, HMRC considers that an overall estimate of £25m-£30m for the full implementation of the project is appropriate at present.

36. Final figures for HMRC's costs arising in 2015-16 are not yet available. HMRC has so far invoiced the Scottish Government in 2015-16 for £4,103,000 for costs associated with the project and implementation programme and the total combined costs for 2015-16 are estimated to be £10.1m, of which about £6.9m is for IT change.

37. Once the Scottish rate is operational, there will be a continuing cost to maintain accurate records of Scottish taxpayers, deal with enquiries and correspondence, and where necessary conduct compliance activity to counter attempts to misrepresent Scottish taxpayer status, especially if the income tax rates are different in Scotland and the rest of the UK. An estimate for the annual running costs of £4.2m per year was published in November 2010 when the Scotland Bill was introduced to Parliament. Since then, further work has been carried out to refine this figure. In written evidence to the Scottish Parliament's Finance Committee in October 2015, HMRC set out that, if the Scottish and UK rates diverged, there would be an increase in running costs. HMRC's customer research has supported this, by clarifying that Scottish taxpayer customers would be more likely to call HMRC if the Scottish rates were different from the UK rates and a divergence in the rates would increase the amount of compliance activity required.

38. As the Scottish rate has been set at 10% for 2016-17, HMRC has advised the Scottish Government that the running costs for the year are estimated to be £1.5m for 2016-17 and £2.0m for future years if the rate remains at 10% (the costs will increase in later years as Self Assessment returns for 2016-17 will be completed during 2017-18). In future, the running costs will be higher if the rate is set at a figure other than 10% - under those circumstances, the costs are estimated to be £5.5m-£6m. These figures do not include costs arising from the long-term solution for RAS pension schemes, which will be implemented in 2018-19, as the details of this solution are still under development.

39. With regards to the work DWP has carried out on its benefits systems to take account of the creation of the Scottish rate of Income Tax, DWP has been

working closely with the Scottish Government to explain the extent and detail of work being undertaken to ensure compatibility with SRIT and to agree the appropriate governance arrangements.

40. In December 2015 there was an exchange of letters between DWP and SG which set out the agreed joint working arrangements and terms for reimbursement of costs incurred by DWP in making changes to both IT and non IT systems.

41. At the point when the exchange of letters was completed the estimated costs were projected to be £1.8m. The costs will be kept under review and the current overall estimated expenditure is now in the region of £1.7m. This is made up as follows:

- £958,770 IT costs
- £732,180 Non IT costs

Further steps that will be taken towards implementation in 2016-17

42. The Scottish rate will be introduced on 6 April 2016. Therefore a key focus for HMRC is ensuring that the final stages of implementation are launched successfully and that employers and pension providers are able to operate the revised PAYE system.

43. On 6 April, HMRC will begin administering the Scottish rate. Employers and pension providers will already have been issued with Scottish rate tax codes ('S' codes) and will operate these. When customers change their main place of residence, they should notify HMRC – HMRC systems will then calculate whether this is likely to change the customer's Scottish taxpayer status for the year and, if necessary, issue a new tax code to the individual and their employer/pension provider. Individuals who pay tax via the Self Assessment system will need to declare their Scottish taxpayer status for the year on their

2016-17 tax return. In addition, HMRC will be working to incorporate the Scottish rate into the digital personal tax account.

44. HMRC will also be carrying out further changes to its IT systems in 2016-17. The changes include amending the Self Assessment system, for example, to include a question relating to Scottish taxpayer status on the return and to ensure Scottish taxpayers pay at the correct rate. Additionally, work will continue to ensure the Scottish rate is taken into account in developing new digital services for taxpayers. The further changes needed to implement the revised process for RAS will be implemented during 2017-18 and 2018-19, but further work will continue to develop the detailed specifications for this aspect of the implementation project.

CHAPTER 4

SCOTTISH TAX ON LAND TRANSACTIONS

The Scotland Act 2012 provides for Stamp Duty Land Tax (SDLT) to be fully devolved to the Scottish Government from April 2015. SDLT no longer applies to land transactions in Scotland. The Scottish Parliament has introduced Land and Buildings Transaction Tax to replace it. HMRC's SDLT project managed the requirements for successful transition to the new Scottish tax, including the switch-off of SDLT in Scotland. The project board included representatives from HMRC and the Scottish Government. Board members were consulted and involved at key decision points to ensure that the project provided effective solutions and value for money.

Steps taken towards implementation since previous report

45. The devolution of SDLT to the Scottish Parliament was delivered on time and to budget, thanks to the successful implementation of IT and business change, effective communications and close joint working between HMRC, Revenue Scotland and stakeholders.

46. From 1 April 2015, HMRC's IT systems were changed to reject SDLT returns for Scottish transactions. HMRC and Revenue Scotland published joint transitional guidance for customers and worked closely with external stakeholders to ensure that customers' tax obligations to the respective authorities were clearly understood. This approach ensured a smooth transition and helped reduce HMRC customer errors and queries to negligible levels.

47. A monthly feed of Scottish land transaction data to HMRC's systems has also been implemented in line with the Scotland Act 2012 provisions.

48. Since 1 April 2015, HMRC and Revenue Scotland officials have worked closely on areas of common interest, including technical tax and compliance

issues, and plans are underway for further exchange of information and joint working.

49. Combined management of the SDLT and Landfill Tax devolution projects produced efficiencies which reduced the total costs of the SDLT by £41k. The total cost of the SDLT project was £937k, of which £224k fell within 2015-16, for IT and other changes needed after April 2015 to embed the transition to Land and Buildings Transaction Tax.

CHAPTER 5

SCOTTISH TAX ON DISPOSALS TO LANDFILL

The Scotland Act 2012 provides for Landfill Tax to be devolved. From April 2015, the UK tax ceased to apply in Scotland and the Scottish Parliament has replaced it with Scottish Landfill tax. The UK tax has been 'switched off' and a corresponding adjustment has been made to the Scottish block grant. HMRC's Landfill Tax project managed the requirements for switch-off of Landfill Tax including impacts on the Landfill Communities Fund. The project board included representatives from HMRC and the Scottish Government. Board members were involved in decision making to ensure that the project provided effective solutions.

Steps taken towards implementation since previous report

50. HMRC initiated the procedures to deregister landfill operators operating solely in Scotland after they had submitted their final returns covering the period ending 31 March 2015.

51. The legislation setting out the necessary changes to existing legislation for the disapplication of Landfill Tax and the Landfill Communities Fund in Scotland, including procedures for the two year transitional period for the Landfill Communities Fund, came into effect on 31 March 2015.

52. The switch-off process was implemented effectively following direct communications to landfill operators affected in the months leading up to 31 March 2015.

53. HMRC continued to work with Revenue Scotland to develop procedures on information sharing on areas of common interest specific to landfill tax under the overarching Information Sharing Agreements.

CHAPTER 6

BORROWING POWERS OF SCOTTISH MINISTERS

The provisions in the Scotland Act 2012 enable Scottish Ministers to borrow for

- *to deal with deviations between forecast and actual revenues, in addition to operating a cash reserve, Scottish Ministers can borrow up to £200m each year within a statutory limit of £500m. Loans will be for a maximum of 4 years;*
- *to deal with temporary in-year shortfalls between receipts and expenditure, Scottish Ministers can borrow to provide the Scottish Consolidated Fund with an appropriate cash working balance. Note that a similar facility existed under the Scotland Act 1998; and*
- *for capital investment, Scottish Ministers can borrow up to an additional 10% of the Scottish Government's capital DEL budget each year within a statutory limit of £2.2bn. Loans will be usually for a maximum of ten years but with the option of a longer period in line with the expected life of the asset;*

Steps taken towards implementation since previous report

54. The Scotland Act 2012 borrowing powers have been in operation since April 2015, in which month loan agreements between the Treasury, Scotland Office and the Scottish Government were put into place for capital and resource borrowing from the National Loans Fund.

55. During 2015-16 the Scottish Government has used £283m of its annual capital borrowing limit and has not undertaken any borrowing.

CHAPTER 7

POWERS TO DEVOLVE FURTHER EXISTING TAXES AND CREATE NEW DEVOLVED TAXES

With the agreement of both governments, further existing taxes can now be devolved and the Scottish Parliament is able to introduce new Scotland-specific taxes. These powers support the ongoing evolution of devolved responsibilities and provide the Scottish Parliament with a new means of achieving policy outcomes, as well as potentially raising additional revenues.

56. This power came into force on the same date as the Scotland Act 2012. To date, neither the Scottish Government nor the UK Government has put forward proposals to create new devolved taxes under this power.

CHAPTER 8

EFFECT OF NEW POWERS ON THE SCOTTISH BLOCK GRANT

Since devolution in 1999, the Scottish Parliament has had almost complete flexibility over how it spends its income, the bulk of which has been provided in a block grant determined by the Barnett formula. As set out in the Command Paper published alongside the Scotland Bill, a fundamental principle of tax devolution is that an element of the block grant is exchanged for the ability to levy taxes. In order to ensure that the adjustment process is transparent and equitable, the UK and Scottish governments, through the Joint Exchequer Committee, have agreed a set of overarching principles as the basis for considering mechanisms for adjusting the block grant.

Steps taken towards implementation since previous report

57. As noted in the third implementation report, the UK and Scottish Governments agreed that the block grant adjustment arrangements in relation to Stamp Duty Land Tax (SDLT) and Landfill Tax should be considered as part of the wider fiscal framework under the Smith Agreement. This framework[2] was agreed in February 2016 and will now be implemented. Further details have also been set out in a technical annex[3].

58. Under this agreement, the two governments have agreed the approach to block grant baseline deductions and ongoing indexation mechanisms for all taxes being devolved or assigned in Scotland.

59. The baseline deduction will generally equal the revenues generated by the relevant tax in Scotland in the year prior to devolution. However, for Stamp Duty Land Tax, this deduction will be reduced by £20m to reflect an estimate of the extra tax generated for the UK government due to forestalling effects (whereby the timing of property transactions were changed as a result of the Scottish Government pre-announcing Land and Buildings Transaction Tax rates and thresholds). The resulting baseline deduction for SDLT should

[2] www.gov.scot/fiscalframework and https://www.gov.uk/government/publications/the-agreement-between-the-scottish-government-and-the-united-kingdom-government-on-the-scottish-governments-fiscal-framework
[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508102/Fiscal_Framework_-_Text_-_Annex_to_the_fiscal_framework_-_15th_March_201....pdf

therefore reflect the revenues that the UK government would have received in this year in the absence of devolution.

60. For a transitional period to 2021-22, the indexation will be effected by using the Comparable Model (Scotland's share), whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method. During this period, the Scottish government's funding will therefore be dependent on the policy choices it makes, on the relative performance of the Scottish economy, and on Scotland-specific demographic change but its funding won't be affected by Scotland's overall population growing differently from the rest of the UK in these years.

61. The two governments have agreed that these arrangements will be reviewed following the UK and Scottish Parliament elections in 2020 and 2021 respectively. The fiscal framework does not include or assume the method for adjusting the block grant beyond the transitional period. The two governments will jointly agree that method as part of the review. The method adopted will deliver results consistent with the Smith Commission's recommendations, including the principles of no detriment, taxpayer fairness and economic responsibility.

62. It should also be noted that:

- the deduction for 2015-16 (£494m) will not be recalculated using these arrangements; and

- to inform the Scottish Government's budget process for 2016-17, the two governments agreed a provisional adjustment of £600m. This adjustment will be recalculated following the end of 2016-17 (using the approach agreed as part of the fiscal framework) and any difference will be applied to the block grant for a subsequent year;

63. For the Scottish Rate of Income Tax, 2016-17 is a transitional year, during which the reduction in the block grant reflects the OBR forecast of revenues that would be generated by a Scottish rate of 10%, while the Scottish

Government can access the OBR forecast of revenues that will be generated by the Scottish rate that it sets.

64. As the Scottish Government has set a Scottish rate of 10%, the reduction in the block grant is therefore the same as the tax revenues available (at £4,900m).

Further steps that will be taken towards implementation

65. As noted above, the UK and Scottish governments have agreed a new fiscal framework to underpin the Scottish Government's increasing powers and responsibilities.

66. The arrangements set out in the agreement will be implemented alongside the Scotland Bill powers. For SDLT and Landfill Tax, these arrangements will ultimately be used to determine the block grant funding for 2016-17 onwards.

CHAPTER 9

OTHER ACTIVITIES TOWARDS IMPLEMENTATION

Forecasts by the Office for Budget Responsibility

67. The OBR has continued to publish forecasts of Scottish taxes (at least) twice a year.

Cash reserve

68. In order to support the transition to the new system, Scottish Ministers are able to make discretionary payments into the cash reserve until June 2016 up to an overall total of £125 million. No such payments have yet been made.

69. From 2015-16 onwards, the Scottish Government is able to maintain a cash reserve using an element of tax revenues, which can be accessed if future tax revenues are lower than forecast. While no such payments have yet been made, the expectation is that these would only be made after the end of the financial year once actual tax revenues are known (i.e. at some point after the end of March 2016).

Budgeting arrangements for devolved powers

70. The agreed budgeting arrangements have been used during 2015-16 in relation to the Scottish Government's spending funded by devolved tax revenues and borrowing.

CHAPTER 10

OTHER REPORTING REQUIREMENTS

71. In addition to the areas covered above (steps taken towards implementation and steps yet to be taken), section 33 of the Scotland Act 2012 requires annual reports on Part 3 of the Act to include:
    - an assessment of the operation of the provisions of Part 3 which have been commenced;
    - an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part;
    - any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.

72. This report is the fourth following the passage of the Act in May 2012. It should be noted that, in accordance with section 44(2)(b) of the Act, all provisions of Part 3 came into force two months after the passing of the Act itself, with the exception of section 25(7) (and Schedule 2) - Scottish rate of Income Tax: consequential amendments - and section 32 - borrowing by Scottish Ministers. Section 32 came into force on 12 December 2014.

73. The Scotland Bill, which implements the cross-party Smith Commission Agreement, devolves responsibility to the Scottish Parliament for the setting of income tax rates and thresholds for earned income. This includes the ability to introduce new bands. The Bill also devolves air passenger duty and Aggregates Levy, and provides that a proportion of the VAT that is attributable to Scotland may be assigned to the Scottish Government’s budget. The Bill provides that the first ten percentage points of the standard rate of VAT and

the first 2.5 percentage points of the reduced rate of VAT will be assigned to the Scottish Government's budget.

CONCLUSION

74. Section 33 of the Scotland Act 2012 stipulates that the Annual Report on the implementation and operation of Part 3 of that Act should be laid on or before the anniversary of the date on which Royal Assent was received, which is 1 May. Due to the Dissolution of the Scottish Parliament in advance of the May 2016 Scottish Parliament elections, this year's report was laid before Parliament in March.

75. The past year has seen us move closer to the full implementation of the Act. Land and Buildings Transaction Tax and Scottish Landfill Tax took effect in April 2015, with Scottish rate of Income Tax due to take effect in April 2016.

76. The next annual report on the implementation of Part 3 of the Scotland Act 2012 will be published, in accordance with Section 33(3)(b)of the Scotland Act 2012, before 1 May 2017.

Annex A – Reporting requirements in the Scotland Act 2012 and where they are addressed in this report

1. *a statement of the steps which have been taken, whether by the maker of the report or by others, since the making of the previous report (or, in the case of the first report, since the passing of this Act) towards the commencement of the provisions of this Part,*

   Chapter 2: Paragraphs 7-11
   Chapter 3: Paragraphs 13-41
   Chapter 4: Paragraphs 45-49
   Chapter 5: Paragraphs 50-53
   Chapter 6: Paragraphs 54-55
   Chapter 7: Paragraph 56
   Chapter 8: Paragraphs 57-64
   Chapter 9: Paragraphs 67-70

2. *a statement of the steps which the maker of the report proposes should be taken, whether by the maker of the report or by others, towards the commencement of the provisions of this Part,*

   Chapter 2: Paragraph 12
   Chapter 3: Paragraphs 42-44
   Chapter 8: Paragraphs 65-66

3. *an assessment of the operation of the provisions of this Part which have been commenced,*

   See chapter 10

4. *an assessment of the operation of any other powers to devolve taxes to the Scottish Parliament or to change the powers of the Scottish Ministers to borrow money, and of any other changes affecting the provisions inserted or amended by this Part,*

   See chapter 10.

5. *the effect of this Part on the amount of any payments made by the Secretary of State under section 64(2) of the 1998 Act (payments into the Scottish Consolidated Fund),*

   See chapter 8.

6. *any other matters concerning the sources of revenue for the Scottish Administration (within the meaning of section 126(6) of the 1998 Act) which the maker of the report considers should be brought to the attention of the Parliament of the United Kingdom or the Scottish Parliament.*

   See chapter 10.

ISBN 978-1-4741-3019-6

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