Clarifying the Scope of the Scottish Rate of Income Tax

Technical Note
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The Scotland Bill received Royal Assent on 1 May 2012 and became the Scotland Act 2012. The Act introduces the Scottish rate of income tax, which is expected to be implemented in April 2016.

This Technical Note sets out the Government's policy intentions in areas where the rate setting power interacts with other areas of the income tax system. They have been developed following consultation with representatives of relevant private sector groups. Any legislative changes necessary to achieve these intentions are expected to be introduced in statutory instruments – these will be published for consultation before they are laid. The consultation is expected to take place in spring 2013.

The following commentary is based on current tax law, and the Government's position in relation to any of the matters commented on may be reviewed in the event that changes are made to the wider tax system in future Finance Acts.

If you have any comments on the paper, please send these by 31 August 2012 to –

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Chapter 1 – Definition of a Scottish Taxpayer

Introduction

1. The Scottish rate of income tax, as introduced by the Scotland Act 2012, will be charged on the non-savings income of those defined as Scottish taxpayers. The rate paid by Scottish taxpayers will be calculated by reducing the basic, higher and additional rates of income tax levied by the UK Government by 10 pence in the pound and adding a new Scottish rate set by the Scottish Parliament.

2. For instance, if the UK basic, higher and additional rates of income tax were 20 per cent, 40 per cent and 45 per cent respectively and the Scottish rate of income tax were 11 per cent, then the rates applied to those defined as Scottish taxpayers for basic, higher and additional rates of income tax would be 21 per cent, 41 per cent and 46 per cent respectively. If the Scottish rate of income tax were 9 per cent, then the rates applied to those defined as Scottish taxpayers would be 19 per cent, 39 per cent and 44 per cent. A Scottish rate of 10 per cent would mean no change from the UK rates.

3. Although the Scottish Parliament sets only one rate (**the** Scottish rate), this effectively gives rise to three rates: the Scottish basic rate; the Scottish higher rate; and the Scottish additional rate. Together these three rates will be referred to as the Scottish main rates.

4. As the Scottish rate of income tax is not a discrete tax it remains covered by existing UK double taxation agreements.

5. The Scottish rate of income tax replaces the Scottish Variable Rate (SVR), which was introduced by the Scotland Act 1998.

6. The non-savings income of a Scottish taxpayer (as defined by Part 3 of the Scotland Act 2012) will generally be liable to the Scottish rate of income tax.

7. Savings income and dividend income (as defined in sections 18 and 19 respectively of the Income Tax Act 2007 (ITA) and to which sections 12 and 13 of ITA apply) arising to Scottish taxpayers will still be taxed at the appropriate UK rate.

8. However, in the interests of avoiding additional complexity for taxpayers, or a result whereby the costs of collection become disproportionate to the revenue raised, the Government proposes that there should be some exceptions to the general rule that the Scottish rate of income tax will always apply to the non-savings income of a Scottish taxpayer. These exceptions (and the rationale for them) are set out in detail at various places below.

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Definition of a Scottish Taxpayer

9. The Scotland Act 2012 inserts new sections 80D-80F into the Scotland Act 1998 which define who will be a Scottish taxpayer for the purposes of the Scottish rate. There are a number of steps to determine this.

10. Firstly, in order for an individual to be a Scottish taxpayer, they must be UK resident for tax purposes – an individual who is not UK tax resident cannot be a Scottish taxpayer.

11. The remaining parts of the definition are based on the location of an individual's sole or main place of residence. If they have one place of residence and this is in Scotland, they are a Scottish taxpayer.

12. Individuals who have more than one place of residence in the UK need to determine which of these has been their main place of residence for the longest period in a tax year – if this is in Scotland, they are a Scottish taxpayer. For example, if an individual with a single place of residence moves house into or out of Scotland part way through a tax year, whether they will be a Scottish taxpayer in that year will depend upon which house is their main place of residence for the longer amount of time.

13. Individuals who cannot identify a main place of residence will need to count the days they spend in Scotland and elsewhere in the UK – if they spend more days in Scotland, they will be a Scottish taxpayer.

14. An individual who meets the definition of a Scottish taxpayer will be a Scottish taxpayer for a whole tax year.

15. There are separate rules which apply to MSPs, MPs representing a constituency in Scotland and MEPs representing Scotland. Such individuals will automatically be treated as Scottish taxpayers, irrespective of where their sole or main residence is located or of where they spend the most days in the UK.

16. Guidance will be published prior to the introduction of the Scottish rate to assist taxpayers in identifying their main place of residence.

Consultation

17. During the passage of the Bill through Parliament, the Government set up a High Level Implementation Group (HLIG), jointly chaired by the Exchequer Secretary to the Treasury and the Secretary of State for Scotland, to address any issues in the lead up to the start of the Scottish rate.

18. HM Revenue & Customs (HMRC) have set up three technical groups which feed into the HLIG looking at pensions, charities and general income tax issues. Members of the relevant representative bodies sit on the technical groups and information drawn from the groups has been used in developing the proposals set out in this paper.

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Chapter 2 – General Issues

19. Part 3 of the Scotland Act 2012 inserts new provisions into ITA and the Scotland Act 1998. Any definitions contained in tax legislation which apply for the purposes of the Income Tax Acts will therefore extend to the provisions inserted by Part 3, subject to any contrary interpretations or definitions contained in the Scotland Act itself.

Partnerships

20. No special rules are proposed, whether the partnership is governed by Scots law or the law in England and Wales.

21. In either case, under Self Assessment, the individual partners are liable to tax on their own share of the partnership's income, each partner being deemed to be carrying on a separate trade. Where the partner is a Scottish taxpayer, such income will potentially be subject to the Scottish rate of income tax in accordance with the general rules for individuals.

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Chapter 3 - Charitable Giving

22. When a taxpayer makes a voluntary donation to a charity through Gift Aid, the donation is made net of income tax at the basic rate, and the charity is able to claim repayment of that tax from HMRC. Under the Gift Aid legislation, the amount paid is treated as the net amount of a gift equal to the grossed up amount of the gift (section 520(2) of ITA). For example, with a basic rate of 20 per cent, a gift of £80 is treated as a gift of £100 on which £20 tax has already been deducted. The charity is therefore able to reclaim the £20.

23. If the Scottish basic rate of income tax were higher than the UK basic rate, charities would benefit as they could claim back more tax in relation to donations made by Scottish taxpayers. Likewise, if the Scottish basic rate of income tax were lower than the UK basic rate, charities would suffer as they could claim back less in relation to donations made by Scottish taxpayers.

24. The Charities Technical Group, consulted as part of this process, were extremely concerned about the potential administrative burden from identifying donors liable at the Scottish rate of income tax in order to make accurate claims. In some cases, it was suggested that charities would need to set up two different internal systems to process claims. The bodies consulted felt that the additional burden would outweigh any potential gains in donations if the Scottish main rates were higher than the main UK rates, provided any such difference was not significant. The Government has taken account of these views and agrees that the additional burden placed on charities would be disproportionate.

25. **Gift Aid for charities will therefore continue to apply at the UK basic rate, regardless of the tax position of the donor**. The Government will keep this issue under review though so that, if the Scottish and UK rates diverge considerably or it becomes possible to provide Gift Aid relief at the correct rate without the currently anticipated administrative burden, the position can be reconsidered.

26. Donors who are higher and additional rate taxpayers are also able to claim tax relief on their donations. This relief is the difference between the higher/additional rate of tax and the basic rate of tax on the total 'gross' value of their donation to the charity. For example, if a higher rate taxpayer makes a £100 donation to a charity, the charity can claim Gift Aid at the basic rate, making the total value of the donation £125. The taxpayer can claim the difference between the higher rate of tax at 40 per cent and the basic rate of tax at 20 per cent on the total value of their donation, so they can claim 20 per cent of £125, a total of £25.

27. Once the Scottish rate is introduced, **Scottish taxpayers will be able to claim relief equal to the difference between the Scottish basic and higher or additional rates**.

28. So, if the Scottish rate were 11 per cent, the total value of a donation of £100 by a Scottish taxpayer would be treated as £126.58. The Scottish taxpayer would then claim the difference between their higher rate (41 per cent) and basic rate (21 per cent) on the

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total valuation of the donation. This would be 20 per cent of £126.58, so a total of £25.32.

29. Tax relief for donations made to charity under the payroll giving scheme is given at source before an employee's PAYE tax is calculated, and is given at their marginal rate. Where the employee's marginal rate is derived from the Scottish rate of income tax then the relief will apply at that marginal rate.

30. Individuals who donate certain shares or land to a charity qualify for income tax relief (at the basic, higher and additional rates). All the tax relief has to be claimed through the Self Assessment return. The approach here will follow that taken for other donations to charities where relief is claimed through Self Assessment – therefore if an individual is a Scottish taxpayer they would receive relief at the Scottish main rates.

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Chapter 4 - Pensions Tax Relief

Occupational pension schemes operating the Net Pay Arrangement

31. The present arrangement is that pension contributions are deductible from pay before the employee's individual PAYE tax calculation is applied. This means that tax relief is automatically given to the employee at their marginal rate of tax. The arrangement is known as the Net Pay Arrangement.

32. **The Government believes that where the employee's marginal rate of tax is derived from the Scottish rate of income tax then the relief should apply at that rate**. The operation of Net Pay arrangements will therefore be unaffected by any differences between the UK rate and the Scottish rate of income tax.

Other arrangements for pension schemes

33. This section applies for personal pension schemes, occupational pension schemes not using the Net Pay Arrangements, National Employment Savings Trust (NEST) and retirement annuity contracts (RACs).

34. Individuals can make regular contributions to certain types of registered pension scheme, often in monthly instalments. The individual may decide how much they can afford to contribute each month, although sometimes it is a fixed percentage of pay.

35. When individuals make contributions to RACs, they are able to claim tax relief direct from HMRC through the Self Assessment process. Individuals in these cases will receive relief at their marginal rate and will not be affected by the introduction of the Scottish rate.

36. Except for RACs, contributions made to these other pension schemes are treated as paid net of basic rate tax using the Relief at Source (RAS) process. Under RAS, the pension scheme claims the basic rate tax element of the contribution from HMRC and adds it to the individual's pension plan. Higher and additional rate taxpayers can claim any further tax relief from HMRC through Self Assessment.

37. Once the Scottish rate of income tax is introduced, if the Scottish and UK rates diverge, Scottish basic rate taxpayers who are RAS scheme members should receive a different amount of tax relief from UK taxpayers. If the Scottish rates were higher, the pension scheme should claim an increased amount of relief; if the rates were lower, the scheme should claim a smaller amount. This could mean additional administrative burdens for pension providers, but restricting relief to the UK basic rate for a Scottish taxpayer would mean that basic rate Scottish taxpayers would not receive the correct amount of relief if the rates diverged.

38. **The Government recognises that relief should be given at an individual's marginal rate, but remains concerned about the administrative impact this could have on the pensions industry.** Given that the Scottish rate does not commence until 2016,

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HMRC will continue current work with the industry on improving the existing RAS process, incorporating the impact of the Scottish rate, to find a suitable way forward which minimises industry costs, but still aims to ensure that taxpayers receive the right amount of relief at the right time.

39. The pensions tax regime from 6 April 2006 applies special tax charges to payments made in certain circumstances, with rates fixed so as to broadly recoup tax relief already given. These tax charge rates are based broadly on the current income tax rates but are designed to incorporate a certain tolerance should rates alter by a small amount either up or down. If Scottish and other UK rates diverge to only a small extent, or for only one year, the outcome may be that the broadness of the brush applied to the calculation is sufficient to accommodate short term differences between UK and Scottish rates of tax. Therefore, to avoid continual administrative and systems changes for pension schemes and HMRC, **no changes will be made to the rates of the pensions tax charges** initially, but HMRC will monitor the position in case any divergence of rates is significant or continues over a period of time, in which case it may be necessary to consider introducing a parallel set of rates for scheme members who are Scottish taxpayers.

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Chapter 5 - Trustees and Personal Representatives

40. Trustees and personal representatives of estates of deceased persons have a residence status for tax purposes. There are different rules for each. There is also existing tax legislation which ensures that beneficiaries of a trust that is subject to Scots law are treated as if they had the same rights to income arising to trustees as have beneficiaries of a trust that is subject to the law of England and Wales (section 464 of ITA).

41. This is already a complex area and the Government wishes to avoid additional complexity. The introduction of "Scottish resident" trusts and estates would add another layer of complications for trustees and personal representatives. **The Government therefore proposes that trusts should retain their current (UK or non-UK) residence status and be taxed at UK rates where appropriate**.

42. Trusts and deceased estates are not generally affected by the Scottish rate of income tax. Income arising to trusts will not be chargeable to the Scottish rate, which applies only to individuals. A body of trustees (on whom liability for tax due on trust income falls), is treated as a single 'person' for tax purposes, and is not an individual. Neither is the personal representative of the deceased acting in an individual capacity.

43. However, trust or estate income arising to or received by an individual Scottish beneficiary would be chargeable to the Scottish rate. There are a number of different types of trust though and there are implications in relation to the Scottish rate when income is paid out to beneficiaries. These would be treated in the following ways.

Bare trusts

44. Under a **bare trust** arrangement, income is treated for tax purposes as arising direct to the beneficiary. As a result, those beneficiaries who are Scottish taxpayers would include this income as part of their total income in the normal way, and **this would be liable to the Scottish rate of income tax**.

Discretionary and accumulation trusts

45. Income from **discretionary and accumulation trusts** is distributed to beneficiaries at the discretion of the trustees. The trustees of UK resident trusts are currently charged on their income at the trusts tax rate (50 per cent - this will fall to 45 per cent in 2013-14) or dividend trust rate (42.5 per cent - this will fall to 37.5 per cent in 2013-14). The beneficiaries' income is treated as being received net of tax at the trust rate, so they currently receive a tax credit of 50 per cent.

46. Income flowing through these trusts loses its character – in other words, irrespective of whether the income arising to the trust was savings or non-savings income all the income would be treated as non-savings income in the hands of the beneficiaries. **Income payments from discretionary trusts will therefore be liable at the Scottish rate when paid to Scottish beneficiaries**.

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47. In broad terms the trustees of non-resident discretionary trusts are only liable to income tax at the trust rate on the UK source income that they receive. They are not liable to UK income tax on foreign source income although they may be liable to tax on this income in the overseas jurisdiction. Discretionary income distributions from non-UK resident trusts are treated as untaxed income of the beneficiary irrespective of whether the trustees have suffered tax on the trust income. The beneficiary may if certain conditions are met claim credit for some of the tax paid by the trustees. Such income should be included by Scottish taxpayer beneficiaries as part of their total income in the normal way, and this would be liable at the Scottish rate of income tax. This would be consistent with the current tax treatment and simple to administer.

Deceased Estates and Interest in Possession Trusts

48. A **UK-resident Interest in Possession (IIP) trust** is one where the beneficiary has a legal right to the trust income as it arises. Under Scots law the beneficiaries have no such right to the income as it arises, but they do have rights which they can enforce against the trustees to ensure that the trust purposes are carried out, and trustees have an obligation to account to the beneficiaries. Despite these differences in trust law, section 464 of ITA ensures consistency of treatment across the UK for tax purposes. Prior to making a payment to the beneficiary, the trustee is required to pay tax at the UK basic rate of tax.

49. Personal representatives dealing with **estates of deceased persons** will not be liable at the Scottish rate of income tax on income arising during or at the end of the administration of the estate. When paying income from the residue of a deceased estate to the beneficiary they will similarly have paid basic rate tax on that income.

50. In either case, the beneficiary could be receiving non-savings income which has borne tax at the basic rate. Currently beneficiaries liable at the basic rate of tax may have no need to do anything further – they would not need to submit a tax return merely to report the IIP or residuary estate income because there would be no additional tax to pay (although some basic rate IIP beneficiaries may feel it worthwhile to reclaim tax in cases where the trustees have borne expenses out of the income to which the beneficiary is entitled). Beneficiaries liable to tax at the higher or additional rates will have further tax to pay and will be required to complete tax returns.

51. If the Scottish and UK rates were to diverge, this would cause a potential difficulty for Scottish taxpayer beneficiaries whose marginal rate of tax is the Scottish basic rate of income tax and who receive some income under the deduction of tax at the UK basic rate. If, for example, the Scottish main rates of income tax were higher than the main UK rates then, strictly, they will have a further small liability. This would need to be collected via PAYE coding adjustments or through Self Assessment. Few of these beneficiaries will currently complete a tax return so it would be a significant exercise to identify them and adjust tax codes to collect the income. The costs of collecting these small amounts would often outweigh the amount collected. If the divergence in tax rate were reversed there would be similar issues for beneficiaries wanting to reclaim overpayments.

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52. Since savings income will still be charged at the UK rates of income tax this would only be a problem at the moment for non-savings income, such as income from rented properties. **Income paid through an IIP trust or deceased estate will therefore be excluded from a charge under the Scottish rate of income tax – in other words the UK rates should always apply to such income**. Beneficiaries whose marginal rate of tax is derived from the Scottish basic rate of income tax would have no further liability in relation to the income received in respect of which the trustees or personal representatives had paid basic rate tax.

53. With **non-UK resident interest in possession trusts** the issues are different as the trustees will only be liable to UK income tax on UK source income and that income will not be subject to the trust rate. The trustees will not be liable to UK income tax on any foreign income that they receive. It should also be noted that the beneficiary's right to income under foreign law in respect of interest in possession trusts can differ from that described above for UK trusts and consequently the treatment of the income in the hands of the beneficiary can differ. In some foreign law jurisdictions the beneficiaries are entitled to their appropriate share of each item of trust income when it arises to the trustees. These are known as Baker type trusts. In such circumstances the beneficiaries are chargeable on their share of trust income. If the trust income has borne UK tax it is treated as taxed income of the beneficiaries and each beneficiary's share is income that has been taxed at whatever rate of tax it has borne. Once the Scottish rate is introduced, this income will be taxed at the beneficiary's appropriate tax rate – **if they are a Scottish taxpayer, they will therefore pay tax at the Scottish rate on non-savings income from the trust**.

54. Under some other foreign law jurisdictions beneficiaries of interest in possession trusts are entitled only to their appropriate share of the net trust income that remains after the trustees have paid trust expenses; these are referred to as Garland type trusts. The beneficiaries are chargeable on the arising basis by reference to the income receivable by them from the trust. This applies whether or not it was paid out by the trustees. The income is treated as a new source of income and will be returned by the beneficiary as untaxed foreign income. **If the beneficiary is a Scottish taxpayer, they will therefore pay tax at the appropriate Scottish main rate on this income**.

55. If trustees have already paid UK or foreign tax on the trust income, the beneficiary can claim relief for this tax, subject to certain conditions being met. This must be outside of their Self Assessment return though.

56. Once the Scottish rate is introduced, **such claims would be able to be set against tax charged at the Scottish main rates, in the same way as is currently allowed**.

<u>Settlor interested trusts</u>

57. **Settlor interested trusts** are trusts where the settlor (the person who put funds into the trust), or certain family members, can benefit from the trust. The trustees are required to pay tax at the appropriate rate. The settlor will be liable at their marginal rate, although they will receive a tax credit for the tax paid by the trustees.

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58. Income in the hands of the settlor will continue to be charged at their marginal rate – **therefore, if the settlor is a Scottish taxpayer, this income will be chargeable at the Scottish main rates**. This will also be the case if there is an offshore structure and the transferor or beneficiary are assessable to tax under the Transfer of Assets legislation at sections 720 and 731 of ITA.

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Chapter 6 - Other Income Tax Issues

59. **Payments to foreign entertainers and sportsmen** are currently subject to a withholding tax at the UK basic rate. Since such persons are by definition not resident in the UK for income tax purposes, **the UK basic rate will continue to apply wherever the entertainer or sportsman performs**.

60. Under the **non-resident landlord scheme**, rents paid to landlords not resident in the UK are also made after a deduction of tax at the basic rate. The Government sees no reason for this to change once the Scottish rate of income tax is introduced, so **the UK rate will continue to apply**.

61. Long-term UK residents who are not domiciled here can pay an **annual charge to be taxed under the remittance basis** (currently £30,000). **This will not be affected by the introduction of the Scottish rate of income tax**. Payments of the charge due from Scottish taxpayers will continue to be paid direct to the UK Exchequer.

62. Under the **Construction Industry Scheme** (CIS), where payments are made to certain subcontractors in the construction industry, deductions must be made on account of income tax, corporation tax or Class 4 National Insurance Contributions (NICs). There are two rates of deduction – one for subcontractors registered with the scheme (20 per cent) and one for subcontractors who are not registered (30 per cent). At present, the rate of the deduction for registered subcontractors is the same as the UK basic rate. The Government believes that it would make sense for the rate of deduction to be a uniform rate throughout the UK, so **no change will be made to the rate of deduction for payments to subcontractors in Scotland** – this will also make it easier for contractors to administer the CIS, especially if they operate in both Scotland and elsewhere in the UK. This will not affect the ultimate liability to tax of Scottish taxpayer subcontractors who will pay tax at the Scottish rate of income tax through their Self Assessment return in the normal way.

63. **PAYE settlement agreements** (PSAs) are an arrangement between HMRC and employers to account for duties on benefits in kind or expenses that are minor, irregular or impracticable to collect using normal PAYE or benefits reporting mechanisms. The duties collected under PSA arrangements are tax and Class 1B NICs. The amount of tax and NICs collected under the PSA may not be exactly the same as the amounts due from the employees if separately calculated, but any variances are tolerated because of the reduction in administrative burdens for both the employer and HMRC.

64. The agreements take the form of a broad-brush calculation based on assumptions about the tax liabilities of the employees – e.g. whether they are basic or higher rate taxpayers. Taking account of whether employees are Scottish taxpayers will make this calculation more complicated, but not to do so would increase the variance between the true liability and that calculated by the PSA. So, **a Scottish taxpayer's liability to the Scottish rates will need to be included in these calculations**.

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65. Incentive awards are a way of rewarding employees and others with cash, goods or holidays rather than increases in pay. Schemes can vary from national promotions to a prize raffle held by a small firm. Rewards of goods or holidays will usually involve the use of a voucher. Employers frequently meet the tax payable on a non-cash incentive award given to an employee by entering into a PSA. Employers and third parties providing incentive awards can also enter into special accounting arrangements for non-cash awards. These arrangements are called **taxed incentive award schemes** (TIAS). Under the arrangements, persons who make awards either to their own or other people's employees, or both, can enter into a contract with HMRC to account directly for tax on the awards. The providers have the option of accounting for tax at either the basic rate or the higher rate on the grossed up value of the awards they make.

66. Unlike awards covered by PSAs, non-cash awards and the tax paid on them under TIAS arrangements remain assessable on the employee. So the employee has to enter the grossed-up value of the award and the tax paid on it on any tax return. But normally no further tax is due from an employee unless the provider has only entered into a basic rate TIAS and the recipient of the award is liable at the higher rate. For reasons of consistency, **the treatment for taxed incentive award schemes follows that of PSAs**.

67. The special 'policyholder' rate of **corporation tax that is applied to life assurance companies and friendly societies on returns ultimately attributable to savers and investors** is set at the same level as the UK basic rate of tax. Since these companies do not fall within the definition of a "Scottish taxpayer", **this rate of corporation tax will not be affected by the Scottish rate**.

68. **Real estate investment trusts** (REITs) are property investment companies that have elected to join the REIT regime. REITs are exempt from tax on their property rental profits. Payments from REITs out of these profits are made as property income distributions (PIDs) and in the hands of the investor these are taxed as income from property. A sum representing income tax at the basic rate must be deducted from the PID when paid to individuals.

69. It would put a considerable administrative burden on REITs to require them to identify if an individual in receipt of a PID is a Scottish taxpayer – therefore, **REITs will continue to deduct at the UK basic rate from PIDs**.

70. **Authorised investment funds** (AIFs) are open-ended investment companies, pooling capital from a variety of investors – the AIF's investments will typically be in stocks, shares and bonds. The AIF itself is chargeable to corporation tax and any payments it makes to investors are in the form of dividends, or in the case of bond funds, in the form of interest payments. As dividend income and interest payments are excluded from the definition of the Scottish rate of income tax, **there are no Scotland Act consequential issues relating to AIFs**.

71. **Property authorised investment funds** (PAIFs) are a type of AIF which invests in property – as such, much of its income is derived from rents on these properties. As a result, when the PAIF makes a payment to any individual investors, this is treated as

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rental income in the hands of the recipient and the PAIF makes a deduction from the payment equivalent to the UK basic rate of tax.

72. The PAIF fund managers may not be able to identify their investors. Even if they can, they will have no way of knowing whether or not their investors are Scottish taxpayers and, therefore, whether they should deduct the UK or Scottish rate of income tax. Therefore, as with REITs, **PAIFs will continue to deduct at the UK basic rate from payments to individual investors**.

73. For both REITs and PAIFs, the Government proposes to extend this treatment so that **Scottish taxpayers will pay tax at the UK rates on non-savings income from PAIFs and REITs**. The Government would welcome any comments from stakeholders on this position.

Payments subject to a basic rate withholding tax

74. Part 15 of ITA legislates for a number of situations where a business making a payment of income to an individual is required to deduct tax at the UK basic rate prior to making the payment. While, in many cases, these would be payments of savings income (as statutorily defined in section 18 of ITA and, therefore, outside the scope of the Scottish rate of income tax), some payments, which are neither savings nor dividend income would, by default, be charged to income tax as non-savings income. These include, for example, certain types of annual payment, including payments from certain non-pension annuities.

75. Similar issues arise here as to those set out above for PAIFs and REITs – that, if the Scottish and UK rates diverge, basic rate Scottish taxpayers in receipt of such payments will face either over or underpayments of tax, and putting in place a system to prevent this would cause a considerable administrative burden to fall on companies making such payments.

76. It is therefore proposed that **payments which are subject to a basic rate withholding tax under Part 15 of ITA should not be within the scope of the Scottish rate of income tax**.

Order of set off

77. The above areas will introduce the concept of non-savings income of a Scottish taxpayer which is chargeable at the UK rates. This therefore introduces a small degree of flexibility in the order in which an individual might want to set off reliefs and deductions from their total amount of income. Current rules in section 25 of ITA enable an individual to set off their reliefs and deductions in a way that results in the greatest reduction in their income tax liability. That flexibility remains, but by re-categorising particular sources as described above, it may result in a reduction in the overall tax payable.

78. Once reliefs and deductions have been applied, there are then specific rules in place within the tax system regarding the order in which the remaining chargeable income

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should be set against the various rate bands. Broadly speaking, the statutory order prescribes non-savings income is taxed first, followed by savings income then dividend income. Chargeable event gains and payments from trustees of settlor-interested settlements are exceptions and taxed last of all.

79. However, these rules do not make any distinction in relation to different types of non-savings income. For example, a distribution of income from a PAIF would be amalgamated with other parts of an individual's non-savings income (e.g. their salary or income from a property) and set against their allowances as a single block.

80. For the Scottish taxpayer, this creates a situation where, if the Scottish and UK main rates diverge, income within that non-savings 'block' could be charged at two different rates of tax. However, **Scottish taxpayers in receipt of non-savings income charged at the UK rates will still be able to benefit from the current statutory approach and arrange their income set-off in such a way as to result in the greatest reduction to their tax liability**.

81. The measure announced at Budget 2012 introducing a cap on the total amount of income tax relief available to individuals may have an impact on this. These rules will commence in 2013-14 and any interaction with the Scottish rate will be considered as the detailed provisions are developed.

Deficiency relief

82. A similar situation arises where taxpayers are able to take advantage of deficiency relief from a life insurance policy. Deficiency relief may be available to individuals when their life insurance policy, life annuity contract or capital redemption policy comes to an end. Individuals may be entitled to the relief if the tax calculation needed when a policy or contract comes to an end gives a negative result rather than a gain, but taxable gains have arisen earlier in the life of the same policy or contract.

83. The amount of the deficiency relief tax reduction is determined using the amount of any deficiency to reduce the amount of income liable at the highest rate and then in sequence at each lower rate. **The relevant legislation will therefore be amended to include income liable at various Scottish main rates in this sequence, factoring in the possibility that Scottish higher rate could be higher or lower than the UK higher rate**.

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