Response from ICAS to the House of Lords Select Committee on Economic Affairs

Call for written evidence on The Economic Implications for the United Kingdom of Scottish Independence

11 June 2012
About ICAS

1) The Institute of Chartered Accountants of Scotland ("ICAS") is the professional body of accountants. We represent around 19,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body; we do not take a political stance and will not take a stand for or against any Scottish independence referendum proposal.

Fiscal policy and taxation

2) ICAS welcomes the opportunity to contribute to discussions on the issues arising from Scottish independence. In this submission we address Questions 3a and 3b, Fiscal policy and taxation.

Question 3 a

3) It may be obvious, but a point worth emphasising at the outset is that the debate on the impact on Scotland, as well as other parts of the UK, of an independent Scotland with a separate tax base is in danger of being conducted in a void. At this stage, there are no proposals for what might be the tax system of an independent Scotland, albeit a consultation has just been announced on proposals on the replacement for stamp duty land tax devolved by the Scotland Act 2012. Without progress on the design of any tax system for an independent Scotland, it is not possible to reach any conclusion on the impact of such a system for any part of the UK. The main conclusion that can be reached at this stage is that uncertainty results from the lack of tax system proposals to assess this impact, and that work is required to address this uncertainty, following which an informed debate would be valuable.

4) In order to stimulate consideration of the issue of tax in an independent Scotland, or in any further tax devolution, and indeed to highlight the complexity of the issues in designing a tax system, ICAS recently initiated a members debate based on a thought leadership paper “Scotland’s Tax Future; What Tax System Would Scotland Want?”, the text of which is attached at Appendix 1. This paper will inform future contributions by ICAS to the debate on Scottish independence and/or further tax devolution and is expected to provide evidence for future inquiries.

5) In the absence of proposals for a tax system for an independent Scotland, consideration of its impact has to be based on a set of assumptions. There is a crucial caveat: - there has to be a clear understanding of what those assumptions cover and how such assumptions might affect consideration of the questions posed. The tax system of any country is made up of a cohesive set of rules, which define who pays tax and on what they pay tax (the tax base), the operation of any reliefs, relationships with other tax jurisdictions, compliance obligations and penalties for failure or evasion. Administrative machinery is essential, possibly including deduction at source and tax collection mechanisms. Tax rates are the final element, but they are only one element of the impact of an overall tax system on an economy and the individuals and businesses living and operating within that economy. Assumptions must be made for each of these aspects for an independent Scotland to answer the questions posed.
Question 3 b

6) To address the question as regards tax rates, it needs to be remembered that there are a number of UK tax rates, any one or more of which might be assumed to be varied, in any combination, under any independent Scottish tax system. The Finance Bill 2012 provides that UK companies will pay corporation tax this year at 24%, or 20% where profits are low (30% or 19% for ring fence profits), but at a marginal rate of 25% where profits exceed the low profits limit. Individuals may pay income tax in the tax year 2012/13 at 0%, 10%, 20%, 32.5%, 40%, 42.5%, 50% or 62.5% (where personal allowances are clawed back), and these rates can vary annually. Individuals may pay capital gains tax in 2012/13 at 0%, 10%, 18% or 28%. The Scotland Act 2012 allows only variation of some of these rates; those at 20%, 40% and 50% and only on non-savings income. As regards consumption taxes, VAT rates may be levied or varied, depending on the membership status of an independent Scotland within the EU, and operate currently at 0%, 5% and 20%. Excise duties on alcoholic drinks may change. Property taxes levied as business rates or on the sale of property, such as stamp duty land tax, are also to be considered but, as devolved (or devolving) taxes are already under consideration by the Scottish Parliament. When revenue generation from tax is to be maintained, any cut in rates in one area is likely to be balanced by an increase in rates in another, by the same government. In view of the point made above at paragraph 5, regarding the need to understand the assumptions in the design of the overall tax system, the impact of any variation of tax rates in Scotland in practice is likely to involve more complex analysis than a simple “higher or lower” approach adopted in some discussions. The comments below are in this context.

Individual impacts

7) The general observation could be made that most people do not like paying tax and, given a legal and legitimate choice, are likely to opt to pay less tax rather than more. Attempts to pay tax at lower rather than higher personal tax rates within the UK - capital gains are taxed at lower rates than income, for example - have resulted in a considerable amount of anti-avoidance legislation within the UK tax system. Likewise, there are extensive provisions in the UK tax legislation to prevent tax leakage from the UK tax net to overseas tax jurisdictions, particularly low taxed areas. The individual behavioural approaches and responses to the tax environment would reasonably be assumed to continue should tax rates differ between different parts of the UK, which may require additional legislative provisions, depending on the policy response taken.

8) One key issue to be addressed by the UK government would be whether any independent Scotland would be simply another non UK, overseas tax jurisdiction as regards the rest of the UK, or any “special relationship” view would be taken. From a tax technical perspective, the question would be whether Scotland would become non-UK for these purposes or whether the current UK anti-avoidance provisions for transactions or individuals in non-UK regimes might be in some way, relaxed. Policy and administrative effort is likely to be needed to identify whether, and what, double tax treaty between Scotland and the rest of the UK tax system might be needed, and the terms of the treaty. Future consideration would need to be given to whether that debate would be part of any potential future independence settlement or would follow thereafter. In summary, not only is a Scottish tax system design needed, in order to determine the impact of independence on all UK taxpayers, but the rest of the UK tax system consequences also require policy design decisions and responses to be formulated.

9) It may be worthwhile to consider a practical example. Take an individual taxpayer living in London and with savings in a postal/internet bank account at a high street retail bank based in Edinburgh.
When that Scottish based financial institution pays interest on the savings the interest might be paid net of a Scottish basic rate income tax (again, depending on the independent Scottish tax system) similar to the UK income tax withheld at present at 20%. That Scottish tax might become “foreign” tax for the purposes of determining a UK tax liability, although current tax law would allow it to be offset against the UK tax liability on the same amount, that requires an additional tax return claim. Repayment of any excess Scottish tax deducted would be determined by the terms of that Scottish tax system and any double tax treaty between Scotland and the rest of the UK, or, alternatively, different legislative provisions may be enacted in both jurisdictions, applicable EU rules permitting. This also applies in the mirror scenario, where an individual living in Edinburgh had savings in a retail bank based in London. It might be that individuals would decide to keep their tax affairs simple by keeping funds within their domestic tax regime. Whether that would result in the movement of funds between institutions in different jurisdictions, or whether those jurisdictions adapted their international business structures to ease the position of the individual saver is a matter at present of pure conjecture. Until more of these uncertainties are addressed, we come again to the conclusion that it is not possible to assess the impact on individuals in this example situation. We can only begin to identify areas on which clarification would be helpful to a future analysis.

10) The above example highlights that tax impacts rarely arise in isolation; an individual’s decision on which savings account provider to save with is also likely to be determined by factors such as the currency and interest rate offered in that jurisdiction, any financial guarantee arrangements and the regulatory and control environment of the financial institution. Tax impacts are also linked to a country’s welfare regime. Where there is high dependence on the state for support, there may be higher taxes levied to pay for that. Where there is greater dependence on private provision, taxes may be lower and savings incentivised through the tax system. Taxes rarely occur in isolation of the wider environment.

**Business impacts**

11) Businesses conducted by individuals in the UK are within the income tax system. Businesses conducted in the UK by companies are within the corporation tax system, and it is these businesses that are considered in this part of this submission. The impact on businesses from a change in corporate tax rates is dependent, as described above, on the nature of the overall tax systems or assumptions made about it. If the key assumption were made, that independence affected only corporate tax rates, then the position is approaching that which ICAS commented on in relation to devolving corporation tax to Northern Ireland in its submission to HM Treasury in June 2011 “Rebalancing the Northern Ireland Economy”. In that, ICAS expressed concern around the consequence to corporation tax law as it would affect the rest of the UK. The views expressed represented those of members of the Institute consulted in recent years over Scottish tax devolution issues, updated by those from several tax committees comprised of members with considerable experience on corporate and cross border business tax issues. It follows that the more changes to a tax system that arose through independence, the greater the scope for other impacts to arise.

It must be emphasised that the comments were made at the start of a debate on different and very specific proposals, and the debate is moving on to one where there is a need for more research, evidence or discussion tailored to the prevailing economic
circumstances of Scotland and the UK. The main points from the June 2011 ICAS submission, relevant to this inquiry, are set out below.

12) The concerns expressed in respect of devolving corporate tax powers to Northern Ireland were the same as those for Scotland, which were included in the final report from the Calman Commission published on 15 June 2009 as “Serving Scotland Better: Scotland and the United Kingdom in the 21st century (Final Report)”. Specifically, the evidence provided in that report, is summarised below:

1) The potential for divergent rates of corporation tax across the UK to create economic inefficiencies as firms react to considerations other than commercial factors, and indeed harmful rather than efficient tax competition.

2) Evidence that a cut in Scottish corporation tax would attract more profit shifting behaviours than create real economic activity. This is an increasing issue in the electronic age and with video conferencing. The application of anti-avoidance provisions relating to profit shifting would have to be widened to deal with this, adding unwelcome administrative complexity for all UK businesses, not just those in the specific devolved jurisdiction.

3) The potentially significant additional administrative burden and tax compliance costs for companies throughout the UK and HMRC from changes necessary to monitor profit-shifting through, for example, transfer pricing legislation. In particular the exemption currently enjoyed by many small and medium sized enterprises would need to be reconsidered if devolved corporation tax powers are to be effective in achieving their aims, given the predominate business profiles in each jurisdiction, even if the devolved corporation tax rates do not vary significantly from the main UK rate. Determining tax residence of companies, branches and permanent establishments would also create additional burdens.

4) The case for substantive reduction in the possible rate of corporation tax for Scotland was considered to be limited in the short term if the level of public services were to be maintained, at least until or unless Scottish Parliament revenues could be raised from other sources. However, the risk if more than one jurisdiction within the UK has corporation tax varying powers, of a “race to the bottom” is likely to be counter-productive.

5) A key driver to devolution of tax powers was the accountability of the Scottish Parliament; this was thought to be better achieved through devolving powers on taxes other than corporation tax, particularly those with a closer connection to the electorate.

6) The volatility of corporation tax receipts on a localised basis rather than from the UK economy as a whole was a concern, given that European Union state aid rules do not permit any shortfall to be subsidised by the UK government in such circumstances.

13) We saw, and see, no case for considering the Northern Ireland tax issues as sufficiently distinct from those of Scotland to reach a different conclusion, particularly around tax competition and complexity.

14) There were other key aspects of tax policy making in the UK which were relevant considerations.
1) Firstly, the principle of aiming for stability and certainty in tax matters at a UK level has been greatly welcomed as a means of making the UK as a whole more competitive on the international stage. Any devolution of corporation tax powers to different parts of the UK would reduce stability and certainty, so could reduce the attractiveness of the UK as a whole as well as the particular jurisdiction. This could make any changes counterproductive.

2) Simplification of the tax legislation and the practical operation of the UK’s self-assessment regime have been called for consistently and we support the Government doing more in this area. Devolving corporation tax powers will require additional efforts from businesses and their advisers working across the UK achieves less, rather than more, simplification.

3) In considering the potential for a reduced corporation tax rate of 12.5% for Northern Ireland (or any rate materially lower than an income tax rate) the behavioural consequence of unincorporated businesses seeking to incorporate to take advantage of this rate needs to be considered, along with any evidence that it would stimulate economic activity on a standalone basis. The UK experience of the years 2000 to 2005 with a 10% and then 0% corporation tax rate gave a marked demonstration of this and resulted in an overall reduction in tax payable on those earnings; we have not seen any evidence that additional economic activity resulted from that approach, hence the lower rates were abolished in 2006.

4) Finally, evidence from members raises serious concerns as to the impact on HMRC resources, and whether HMRC would be able to cope with either the changes required or implementation of such devolved powers at any stage in the current spending round. We have expressed in the past concerns over delays and service levels at HMRC, which were also addressed by House of Commons Committee last year. Any additional resources required will have to be fully costed, should any devolved power be required to meet such costs. There may be both fixed costs, which will be presumably incurred up front, when the expected revenue generation will be undetermined, and variable costs of operating increased legislative burdens in, as suggested above, areas such as transfer pricing.
Appendix 1 – “Scotland’s Tax Future; What Tax System Would Scotland Want?”

Introduction

ICAS – the professional body of accountants – is in an interesting place when it comes to tax devolution.

By tax devolution we mean any form of control of taxes passing from Westminster to Holyrood, whether under the current Scotland Bill, emerging discussions on full fiscal independence, or anywhere in between. As probably the single largest body of financial and tax experts in Scotland, with members throughout the world, ICAS has the depth of knowledge and experience to inform any debate over tax devolution, highlighting opportunities, pitfalls, administrative issues or behavioural responses. We have a wide range of overseas experiences and insights into the workings of the best, and less successful, practices. The principles are the same whichever part of the UK may seek or obtain tax powers, but when aligned to the political landscape, the Scottish example has particular salience. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. So it is in the enviable position of having both the key competencies and focus to inform, and, arguably, lead the debate on the most interesting question of 2012 – what tax system would Scotland want?

This paper is not written with a political perspective, or to address the single, narrow topic of what the rate of a particular tax should be; instead it approaches the issue from a much broader and more challenging perspective. It seeks to share ICAS insights into the many complex issues and decisions involved in tax system design, whether this design is driven by the necessity of raising revenue, the opportunity those new tax-raising powers might bring to deliver more innovative or better funding solutions, or a mixture of both. It seeks to broaden the discussion well beyond the debate on the current Scotland Bill provisions, which use as a basis the existing UK tax system and some limited tax varying powers. It also contributes the experience of decades of work which ICAS members and staff have undertaken, often without public profile, with the UK Government and its agencies on the shared agenda of a better-balanced outcome for all tax stakeholders. This paper also refers interested readers to recent relevant research work in this specialised field.

The UK tax system has many imperfections; the complexity that comes from over 200 years of accumulated drafting and tinkering; challenges regarding the fairness of the sharing of the tax burden, and difficulties with HMRC computer systems and administration. Although any transition to fiscal devolution would have to start from here, what exactly is the destination? What tax system would Scotland want? What tax system should any Government of Scotland propose to meet the required revenue-raising targets as well as wider key principles, such as fairness, high levels of acceptability and compliance, low costs of collection and ease of administration? How practical and cost-effective would any transition be from the current system? To take matters forward, this paper divides these topical and highly important issues into six key questions that need to be explored.

The aim of this paper is to develop these questions and stimulate debate amongst members. Whilst the debate cannot abandon the practicalities of any tax system change – which may limit, perhaps severely, any aspirations or wishes for change – nevertheless it is worthwhile focussing on what a tax system can and should achieve, to also inform the approach to those practicalities. Once members’ insights have been gathered, the output and topics for debate will be shared more widely amongst interested parties. Members’ comments are requested by the end of May 2012.
Key observations

Conclusions can be drawn on a way forward once the wider debate mentioned above has taken place. However, some observations are already worth making.

Firstly, the Scottish Government has at present neither an established mechanism, nor the expertise or resources to respond alone to these questions. The reservation of tax powers to Westminster means it has to be questioned whether the Scottish Government has the full understanding of the complexities of the operation of a tax system to enable it to opine authoritatively on this topic. It needs to address this gap urgently if any worthwhile progress is to be made to meet public expectations that it is making any credible attempts to move the tax devolution agenda forward in the optimum fashion. It would be helpful in the discussion regarding devolution (whenever and under whatever provisions that takes place) to know when and how these questions might be addressed. After all, raising revenue will be fundamental to the operation of any new constitutional arrangement, and the outcome of the debate could have a very direct and personal impact on every Scottish taxpayer. ICAS is happy to contribute the skills and expertise of its members to discussions to take this forward, and to suggest sources and analyses of interest and relevance.

Secondly, the complexity of tax systems around the world and their interaction, both structurally and operationally, is more than anyone would set out to design now. This complexity should not be underestimated. The current UK tax provisions are little understood or believed except by those who have spent their careers trying to navigate through the thousands of pages of legislation, guidance, forms and deadlines; a matter not to be taken as an expression of professional or intellectual arrogance, rather one of sad realisation based on sometimes painful practical experiences.

Thirdly, the general public are often dissatisfied and confused by their interactions with HMRC, and might vote for any change as a promise of improvement. But what is this change to be? You do have to start from here. As anyone who has looked at any isolated change to the tax system recently, such as the brief foray into the zero and 10% corporate tax rates in the past decade would know, the scope for getting any major change wrong is massive and can have serious consequences for tax yield. There is also much opportunity to learn from other regimes, existing expert studies and the talent and expertise pool in Scotland and of Scots.

Finally, the design of a new tax system, or any form of tax devolution, is so large a responsibility it cannot and should not be rushed. It will be far from easy to design and to implement. The inevitable efforts and pain need to be because the case is made based on research and evidence, that something better can and will be delivered. Will it be worth it, and why? Political leaders and others may be interested in the observation in the Mirrlees report “Tax by Design”:\footnote{Available from The Institute of Fiscal Studies website at http://www.ifs.org.uk/mirrleesReview/design, page (iv).}

In addition to administrative practicality and the difficulty of turning economic intentions into robust legislative language, proposals for tax reform are, of course, constrained by politics – not least the unfortunate observation that those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful.

If early tax devolution is decided upon, it will only be practical to adopt the current UK tax system with as little change as possible, but with the administrative system costs to be borne.
A fresh approach will probably take at least a decade of effort and disruption to achieve. But not to take those steps could be to compromise on principles and opportunities, for the reasons set out in this paper. That could lead voters to the stark question: is there then a real point to tax devolution?
The key questions

It is proposed that six key questions need to be answered to move the debate forward, and determine what should be on the tax agenda for Scotland. Each of these is addressed in overview below. One caveat however: this is not intended as a complete thesis but rather an overview, based on existing research and publications, and ICAS experience, from which insights and ideas might be drawn. Other questions and approaches will no doubt emerge, and the issues of practicalities can be addressed as a next step, but an agenda for a debate is always useful.

The starting point for a new tax system is a blank sheet of paper. There is only one assumption; that raising taxes is essential to fund public services. It may be helpful to apply the debate to known or given factors, such as the population profile of Scots and business base as at the start of 2012, but only insofar as it may prove the revenue-raising adequacies of the tax system once designed, not to affect the design.

Question 1 - What principles should determine the ideal tax system for Scotland?

Developed economies’ tax systems are a relatively modern phenomenon, most having seen exponential growth in the last 50 years. Tax systems are also man-made, by politicians with a generally limited understanding of the detail of what they do and limited control over the tax administrations they appoint as operators.

It follows then that the people should shape the decisions on the governing principles to be applied, and the establishment of tax policy, by engagement in the debate with elected leaders and policy makers. High-level engagement is perhaps more practical than universal involvement in the detailed drafting of the legislation and the design of the administrative steps that put those principles into practice and make the tax system a reality. But an understanding of the consequences is relevant to the decisions on principles; these consequences need to be considered without allowing them to impede progress on design.

Thinking about tax from the basis of principles, through policy, to practice, is neither new nor particularly controversial for Scots. Adam Smith started this in 1776 in his “Inquiry into the nature and causes of the Wealth of Nations”, with four maxims with regard to taxes; the burden proportionate to the ability to pay (sometimes called a progressive tax approach), certainty, convenience and efficiency of collection. Many of these principles were reflected in an exercise undertaken by The Institute of Chartered Accountants in England and Wales in 1999, when it identified “Ten Tenets for a better tax system”. These comprised principles behind a better tax system; that a tax system should be: statutory (enacted and scrutinised by Parliament), certain, simple, easy to collect and to calculate, properly targeted, constant, subject to proper consultation, regularly reviewed, fair and reasonable, and competitive.

Similar themes were echoed when the current UK Government defined its view of the principles for the UK tax system in 2011 as:

- “Taxes should be efficient and support growth;”
- Taxes should be certain and predictable;
- Taxes should be simple to understand and easy to comply with; and
- The tax system should be fair, reward work, support aspiration and ask the most from those who can most afford it.”

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2 Available from the ICAEW website at http://www.icaew.com/~/media/Files/technical/Tax/Tax%20policy/Ten%20Tenets%20for%20a%20better%20tax%20system
These short and simple principles are rather neat. Scotland can come up with its own, or have a different emphasis. It is when these principles are translated into policies and legislation that it becomes more interesting, as trade-offs, contradictions and piecemeal developments start to add weaves of interaction and complexity. To understand more about these issues, and prepare for the next questions on the list, time would be well spent with a read of the 2011 Institute for Fiscal Studies Mirrlees Review, “Tax by Design” (or even just its introduction). That paper’s detailed examination of the topic raised further concepts and 21st-century factors influencing policy designs, such as:

- the changing importance of particular business sectors in the economy
- the changing demographics in the working population and households
- the interaction with benefits systems (negative taxes) in addressing inequality in incomes
- globalisation, particularly the role of technology in international business transactions
- the influence of the European Union, with its control over VAT and dislike of tax havens.

The debate in recent months has focussed on the competitiveness of a tax system, particularly focussing on the headline corporate tax rate. For the purposes of this exercise, this particular question would ask where competitiveness as a principle would sit in the relative priorities of the tax system design, rather than fix an answer or target rate.

One caveat however, the European Union’s rules on tax systems, and State aid in particular, cannot be ignored – unless of course Scotland is not part of the EU. The European Parliament is also considering enthusiastic proposals by a number of European countries, towards a Common Consolidated Corporate Tax Base; effectively an EU set of tax rules for companies based in the EU, overriding domestic provisions, except for decisions on tax rates. Disputes over EU tax issues take a long time to resolve.

The answer to Question 1 sets the aspirations and principles to underlie the rest of the tax system design.

**Question 2 - Should tax play a wider role than raising revenue?**

Wider policy issues can sometimes enhance, and sometimes confuse, tax principles. What other role, if any, should tax play in a future Scotland?

The tobacco industry tax has for a long time now been associated with the costs of treating the health consequences of smoking, regardless of whether that was its original purpose. The recent debate on the costs to health and health systems of alcohol abuse, even with significant alcohol duties already applying has raised this as an issue again, albeit in Scotland as a minimum pricing issue given the lack of tax powers.

A choice may be made to address the obesity issue with a tax on selected foods; that debate has been taken forward recently by Denmark in its introduction of a tax on foodstuffs with a higher fat content, and Hungary with a similar response but a broader categorisation including sugar. Sugar taxes in fizzy drinks are under serious consideration in parts of the USA. In all of these, tax is seen as a route to influence behaviour against consumption, based on what a government considers unhealthy.

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4 Available from The Institute of Fiscal Studies website at http://www.ifs.org.uk/mirrleesReview/design
7 See observations on the new Institute for Fiscal Studies project to investigate the impact of these types of policies, available at http://www.ifs.org.uk/publications/5712.
Moving beyond health, Bill Gates’ report to the G20 leaders Cannes Summit in November 2011 also supported carbon tax measures, to address climate impacts and address issues of social responsibility and redistribution of wealth on a global scale. These principles can also be localised; the UK already has a landfill tax aimed at encouraging recycling but is redistribution of wealth a design feature to build in, and how?

This might also be a time to consider whether national insurance contributions should be recognised as a tax, in that they generate revenue for current public spending outflows, rather than as a set aside to fund future retirement provision on a compulsory contributory principle, or both.

After addressing Question 2, the system design principles at least start to take shape.

**Question 3 - Who should pay tax in Scotland?**

The Mirrlees report mentioned above included recent tax yield and demographic statistics for the UK, which can be taken, at best, as a proxy for the shape of those statistics for Scotland for the purposes of starting this debate. (Let no-one be misled, there are no official statistics for tax paid by those in Scotland, simply because there has never before been a need to measure them and the mechanism has never been set up. This is discussed further under question 6 below).

The first need is to define who would, and would not, be a Scottish taxpayer? Start with individuals, where we can look to recent work in connection with the proposed Scotland Bill provisions to allow limited income tax varying power to the Scottish Government. (Companies currently have a separate tax regime.) Both the UK and Scottish Governments took a straightforward approach to taxation of individuals, fitting those limitations, of regarding “Scottish taxpayers” as a subset of “UK taxpayers”, broadly on the basis of where their main home was. A number of anomalies were found as to the treatment of mobile workers; naturally any existing anomalies in the determination of a “UK taxpayer” would carry through. That taxpayer base has the advantage of relying on known rules (albeit the UK rules are likely to change in 2013) and having an automatic default for an individual Scottish taxpayer to being a UK taxpayer, so setting out the tax boundary with the rest of the UK.

However, if starting with a blank sheet of paper, would the Scotland Bill’s approach to income tax be the optimal one? An example of one disadvantage of the approach is given by the current definition of a “Scottish taxpayer” being based on the definition of a UK taxpayer, according to rules of UK tax residence. That Scottish taxpayer “subset” could then be altered by UK decisions, taken at Westminster, on the definitions of UK tax residence, decisions not taken in Scotland and subject to potential ongoing change, albeit that the changes may only affect a relatively small number of taxpayers.

Perhaps those rules aren’t ideal, given that the latest UK consultation process is being extended due to issues with the complexity of the proposals and their impact. Do other international regimes provide the answer?

For companies, is it just Scottish incorporated companies, or any companies with places of business in Scotland, or selling to or from Scotland which should pay tax in Scotland?

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Whether a company is incorporated in Scotland or England and Wales has had so little impact in recent years it has been a decision of administrative convenience at the time of set-up rather than of import or consequence for the vast majority. The place of business rules might be expected to dominate.

For international businesses - which would then, by definition, also include those who do business inside and outside Scotland but within the UK - this area is fraught with complexities in compliance. Tax jurisdictions across the globe try to make sure they have their fair share of taxing rights; through defining who pays tax, and also what will be taxed in each tax regime – known as the transfer pricing issue. Each tax jurisdiction demands proof that transfer prices have allocated fair profits and tax to the appropriate exchequer, so the administrative consequences of these rules for businesses operating across the UK could be significant and result in an increased compliance burden. ICAS expressed its concerns on this matter in representations submitted in 2011\(^{10}\); subsequent comments have been in relation to the balance between any advantage of a lower tax rate against the disadvantage of a greater administrative burden for all.

Beyond that, a number of key exemptions are granted in different tax systems, commonly for organisations such as charities (including schools and universities). Focussed exemptions are also given to particular types of income; these vary from miners’ free coal, to employees’ Christmas parties (within limits) and asbestos compensation, from electricity micro generation to players in the UEFA Champions League Final 2011. The list of reliefs examined by the Office of Tax Simplification in its March 2011 report\(^{11}\) identified 1,042 in the UK tax system although a small number (less than 50) mainly of limited use or expired, have now been removed. In comparison to the existing system, there is no doubt that simplification could be achieved. The Office of Tax Simplification reports about reducing the complexity of tax reliefs and interactions within the system could also be read as a list of “things to avoid putting on the blank sheet of paper”, but also demonstrate the consequences in a tax system of trying to do too much for too many different interests. Which leads to question 4.

**Question 4 - What should be taxed?**

Probably the most fascinating of all questions relating to this matter, as it really includes separate issues of the tax source (the activity, such as earnings or profits, ownership of capital or wealth, consumption), the taxable amount (the calculation of the earnings or profits, less reliefs or exemptions) and the tax rate(s). All of these separately and together are what makes a tax system, not just the tax rate.

This is also where the interaction of the principles becomes evident. For example, if one chosen principle for the tax system is simplicity, then the system design would have simple rules for taxable activity – such as all earnings, profits, gains, pensions – then apply one of the simplest taxable amount calculations – the cash receipt – and tax rates would be a simple fixed and flat percentage.

But if another chosen principle is that a fair tax system should be based on ability to pay, then a simple flat tax rate does not deliver that; progressivity of higher tax rates for higher incomes and greater affordability would be demanded.

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Why is the existing UK tax regime so much more difficult? A simplistic answer is because of legislative baggage, because cash receipts can be manipulated - if your employer pays your rent directly to the landlord, whose taxable receipt is it? - and are not currently regarded as giving the recognised measure of the net economic or business performance or health. However, the possible use of cash receipts and other simpler approaches for smaller businesses are now the subject of an HMRC consultation12, following a review by the Office of Tax Simplification13 and the Department of Business, Innovation and Skills14; their research and observations will be informative in this debate.

Radical outcomes might be possible and practical. The UK system currently has separate systems for taxing investment income and capital gains, once realised. The rules are lengthy and complex. Other countries have tax systems based not on realised income and capital gains, but a deemed return on invested capital; the Netherlands for example taxes an annual 4% deemed return on relevant wealth; ability to pay is simply assumed and the compliance burden much less. Some of the alternatives to consider based on other jurisdictions’ practices were set out in the Office of Tax Simplification report referred to above.15

Would, or should, inheritances be taxed? Many estates now involve trust arrangements (a trust being a legacy of protection of land and wealth in past generations, perhaps as far back as the Crusades) and a large proportion of the tax code deals specifically with this area. Is it worth looking again at this for the Scottish taxpayer base? Much value is still held in the form of land, on which a transfer tax (stamp duty land tax) is currently payable. What about a simpler, combined approach to taxing these?

This also leads to the question of what activities or groups should be favoured, or otherwise, in the ideal tax system. Do we continue the UK system of favouring entrepreneurs on capital gains and inheritances on the basis that they are employment creators and should be incentivised? Certain types of growth-related activity, such as research and development, often gain support, but again we get back to principles. If economic competitiveness is a key principle, does that mean favouring particular sectors or activities, and which ones, and how? Usually this means adjusting the tax base (the taxed profits) rather than the tax rate, but international tax competitiveness is an ever changing field. Any government needs to make sure that the form of any tax rate or tax base reductions do result in economic growth and so tax yield replacement, rather than a permanent loss of tax revenue without any benefit.

With an ageing population, could Scotland afford to continue the more generous personal allowances for the over 65s, particularly if there is tax relief given on pension contributions – even taking account of the recent Budget announcements? With the challenge of getting school-leavers into work is it worthwhile improving their chances of being employed by giving them and their employers’ tax breaks, or more relief for training costs? Is it time to integrate income tax and national insurance contributions, which might highlight that earned income is more highly taxed than unearned income, and taxed according to different rules? This is not to discuss mainstream party politics but to suggest how wider consideration in our blank-sheet-of-paper world may highlight some different approaches needed for the 21st century.

William Pitt in 1796 presided over taxes on dogs, windows and male servants. Recent calls have been made for taxes on carrier bags, cyclists and tourists. ‘Who pays?’ is always difficult to answer and exercises many minds; popular consensus on this may take time.

12 HMRC “Simpler income tax for the simplest small businesses” March 2012
13 The Office of Tax Simplification “A simpler income tax for the smallest businesses; a discussion paper” July 2011
15 The Office of Tax Simplification “A simpler income tax for the smallest businesses; a discussion paper” July 2011
It is also necessary to consider taxpayer behaviour, and the behavioural response to tax legislation and changes. Most people don't like paying tax. Most people will try to avoid paying tax, mostly within the law (tax planning or avoidance) but sometimes outside it, through tax evasion. So whilst you can design any tax system you want, it needs to be workable and collect what you want it to.

This means mechanisms to pursue tax evasion and address tax avoidance; a strong compliance and enforcement regime penalising evasion may be needed. For tax avoidance, the decision is about what behaviours to tackle; where is the line between acceptable and unacceptable tax planning? Another principled debate is needed here for the tax system to be designed, with contributions no doubt from informed sources such as Graham Aaronson QC’s Study Group report on anti-avoidance legislation16.

Finally, there is the geographic question, particularly for businesses operating overseas as well as in the UK. Does the system aim to tax profits generated in Scotland, or owned by Scottish companies, or use another approach? The UK is at present party to a number of international tax agreements, which, according to the Organisation for Economic and Social Development's principles, determine the jurisdiction with taxing rights over property or income, and of relevance to companies and individuals. Territoriality has become the emerging theme for the taxation of international business groups globally. Whether some protest groups like it or not, the UK and many other jurisdictions permit, indeed have rules designed to facilitate, an acceptable level of tax planning internationally. Should Scotland sign up to the same principles of territoriality and network of double tax treaties independently? Would this be an absolute necessity in order to gain the tax efficiencies they deliver for businesses located here, such as not having a cash-flow disadvantage from suffering withholding taxes, which is key to competitiveness, and being an acceptable, never mind attractive, business location. Is there a credible argument for taking sectoral favours further and adopting tax haven status for money box companies based here, as is the case for other small jurisdictions such as the Channel Islands? How would the EU view that?

The shape of tax systems changes whichever jurisdiction is reviewed, but each needs to be seen in its entirety, rather than piecemeal. This is probably a matter where learning from overseas systems could be most informative.

Question 5 - Who should run any new tax system in Scotland?

Once the tax system is designed, the administrative resource can be aligned accordingly. Even more decisions are then needed; what accountability should there be of that resource to the Scottish Government? Recent examination of HMRC by the House of Commons Public Accounts Committee has revealed gaps in expectations of governance, never mind scrutiny, of the HMRC Board; the outcome of the current Cabinet Office review might be informative. But with Scottish Parliamentary procedures and principles already in place, how would these be built on to achieve the types of performance management and accountability that a tax authority might be expected to deliver?

The UK tax system is run by HMRC, based on massive IT systems developed over many years. Would a devolved tax system require a new Scottish tax administration to be established or would it be outsourced to HMRC? What would it cost and how long would it take to establish? With a largely England-based technical division, and following recent reorganisations, HMRC has arguably neither the expertise nor capability to staff a Scottish Tax Administration without major re-engineering.

16 Available from http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF
HM Treasury and London based HMRC staff currently drive the majority of policy decisions; the current HMRC staff in Scotland do not have the range of policy and management experience, nor operating structure, to operate a separate tax system at this time.

This question was identified in the Scottish Government paper last year\(^{17}\) but perhaps the question would need to be addressed with a specific design in mind. If an outsourcing approach is considered, why limit consideration to HMRC; why not consider, say, the Australian administration, which on some National Audit Office analysis seems to operate with greater efficiencies\(^{18}\)? Bear in mind also the potential lack of economy of scale in a tax system run for Scotland, at less than 10% of the size of the UK; a different cost-effectiveness and efficiency model from that for the UK may be desirable to achieve value for money.

**Question 6 - What would be needed to implement any tax devolution in Scotland?**

This is a bit of a chicken and egg dilemma; until the process of designing a tax system is complete, including who should pay tax and on what, it is impossible to know what it will yield and therefore whether it will achieve its economic tax raising purposes. The data that might be needed to prove economic effectiveness, such as statistics for the Scottish taxpayer base of individuals and businesses, is not held by anyone at present; for the simple reason it has never been, nor had to be, collected. A significant data-gathering exercise seems on the horizon if there is to be any tax devolution, as well as extensive economic and behavioural modelling exercises. The Barnett formula impact debate may use or provide some of this data as well.

Then there remains the need to identify the Scottish taxpayer base. How? There are no complete, tax-system-ready records of who is in Scotland at the moment (if that’s the tax base you decide). HMRC can select details according to postcode but only for those “live” on the system, and there are serious concerns over data accuracy. Reporting of address changes, immigration and emigration render this an ever moving target. The issue for companies was set out above – there is a less immediate linkage of taxable profits to postcodes, given businesses may have many offices or depots – so that exercise too is needed to decide which companies and what proportion of business profits would fall within a Scottish tax net. The compliance burdens and competitiveness impact were outlined in ICAS representations in summer 2011\(^{19}\) and addressed at page 6 above.

Any departure of all the Scottish taxpayers (once defined) from the UK tax regime would introduce the scope for potentially interesting negotiations with HMRC on handover matters, such as tax deferrals or exit charges from the UK tax system, as arise for those leaving UK tax residence. This may result in a requirement for the establishment of a separate tax administration for any devolved tax powers or jurisdiction, or some other mechanism to avoid “HMRC Scotland” arguing with “HMRC UK”; a situation commonly agreed to present quite a conflict of interest and accountability.

The tax provisions would then have to be passed into legislation, possibly a lengthy process of drafting and review. There are around 80 Acts of Parliament at present relating to UK tax and national insurance contributions with provisions in effect, not to mention a huge quantity of secondary legislation and guidance.

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\(^{17}\) Corporation Tax: Discussion Paper Options for Reform, August 2011.
\(^{18}\) Report “HM Revenue & Customs Engaging with tax agents” 13 October 2010.
The massive volume of existing legislation is directly related to the number of things the tax system is trying to do; the number of taxes, types of taxpayers, rates, reliefs etc – complexity – plus the drafting style of the legislation. That people just don’t like paying tax mean that a plethora of anti-avoidance provisions abound, not always very efficiently or effectively. Whilst in theory a different approach to legislative drafting might be taken with the blank sheet of paper system, it would be a drafting approach not yet developed.

At present it takes a UK Government at least a year, probably nearer two, to shape, draft and enact one Finance Act, so getting to grips with a realistic timescale for any tax devolution is essential, even once the Scottish Parliamentary processes and procedures have been decided. To design and implement an independent tax system in Scotland from scratch may realistically take at least a decade if not two, shorter if a more limited devolution of powers is involved. Transitional provisions for taxpayers to move from the UK to any new system would also need to be considered, with decisions on changeover dates and records, and no doubt lots of forms to be filled in unless smart thinking is applied. Adopting the conclusions of the Mirrlees report might shorten this process, but only perhaps if it received wide support. It may be that as a matter of practical reality the decision is made to adopt the existing UK tax system with the potential for devolved changes over time, but that will defer, rather than avoid, this debate.

Good and clearly established relationships with overseas tax jurisdictions are key to business and economic competitiveness, through the operation of the Double Tax Treaty network as well as cooperation agreements. It is likely these would need to be established and maintained for a devolved tax system as well. Changes to tax systems do not necessarily cause the principles in Double Tax Treaties to fail, but what is the position of any change in the tax authority at the same time? Would any devolved or independent negotiating position be seen as weaker, being from a smaller and newer tax authority? A clear position on how any tax system changes would impact on business competitiveness in this area is an early requirement.

This final question is the one where practicalities and processes loom largest. Given the competitiveness agenda of most countries in economically challenging times, and the need for many for certainty in a world where uncertainty may be seen as risk, is it important that a process and timetable for this debate, or the destinations, are set out sooner rather than later? Or is time better spent in design and on principles? ICAS members welcomed the sentiments behind the UK Coalition Government’s Corporate Tax Roadmap in 2010, and would welcome continuation of those principles of a clear direction of travel. As stated above, this paper is about starting the debate on tax system design options in the light of the devolution debate. Much more will no doubt be written in due course on the practicalities.

But whichever tax future is chosen, there is likely to be agreement that it would be helpful to optimise the benefits of a chosen system and minimise the costs and adverse consequences of change - we come back again to an area where ICAS members contributions to the debate may be hugely valuable.

The ICAS debate

A basic tenet for this paper is that ICAS members have a contribution to make to the debate on Scotland’s future, its meaning and implications for those in Scotland, the rest of the UK and beyond. ICAS has a duty to act in the public interest, which means that we should contribute information and insights to the debate, based on the considerable interest and experience of our members in technical areas such as taxation, but including also pensions, governance and regulatory matters.

This paper is the first in a series that aims to do this; we are seeking to ask the questions in key areas that those on all sides of the debate should address over the coming months.

Members are invited to contribute their views on this taxation paper, the questions it identifies or those that should be added, deleted or altered. Written responses can be emailed to tax@icas.org.uk, preferably by the end of May 2012. After the initial round of member consultation and debate, it is envisaged that wider events and discussions will take place later in 2012.

For the avoidance of doubt, ICAS will not be taking any political perspective or taking a stand for or against any referendum proposal.