A Scottish Approach to Taxation
Some Observations

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1. Income Tax

Responsibility is generally viewed as something that should be done from a legal or moral standpoint. However, it also implies a duty of care. Legislators have a duty to create legislation that is seen to be fair and can be practically implemented and operated. While legislative processes seek to avoid the creation of “bad” law, Margaret Hodge MP commented (at the Responsible Tax for the Common Good Conference last year) that MPs find it difficult to challenge the work of tax experts since they rely on them to create tax legislation.

There are now two tax jurisdictions in the UK. Which jurisdiction a UK taxpayers falls under is determined by the “close connection” rule in the Scotland Act (2012). This rule means that someone with a main residence in England who earns most or all of their money from working in Scotland will not be a Scottish payer even if that person spends most of his / her time in Scotland – e.g. oil industry (oil rigs), major construction projects – due to the nature of their accommodation. Has an estimate been made of the amount of income tax paid by this group of taxpayers? While financial sector workers who work in London with a main residence in Scotland are Scottish taxpayers, the nature of their accommodation – e.g. own property, long-term lets – means some will have scope to change their tax jurisdiction if income tax rates diverge.

Were real life examples considered during the legislative process to determine the implications of the “close connection” rule? Probably not since HMRC only provided examples in their technical guidance published in June 2015. If this had been done, perhaps an alternative method – e.g. most time, most earnings – would have been devised to determine tax residency within the UK?

Will the general public view this legislation favourably or adversely? Perhaps this should have been determined during the legislative process rather than waiting to find out afterwards.

Significant amounts of income tax are raised from relatively few UK taxpayers:

HMRC (2014/15)	**Percentage of Income Tax Raised From Each Taxpayer Group**
Bottom 50%	9.8%
Top 50%	90.2%

Top 25%	74.9%
Top 10%	58.3%
Top 5%	47.2%
Top 1%	27.3%

There are different views of the impact of higher taxes on higher taxpayers. However, a fact-sheet published in 2014 by the Scottish parliament expected some taxpayers to relocate to the more favourable UK tax jurisdiction if the two tax regimes diverge, acknowledging that “additional rate taxpayers react the most to changes in tax rates”. Some may even be tempted to do a paper relocation, which is tax evasion.

Will having two tax systems in the UK influence hiring decisions? This is a difficult question to answer. However, Professor David Bell’s report (2015) for The Hunter Foundation commented: “Some employers are taking advice on how to compensate employees should tax rates differ between Scotland and the rest of the UK.”

HMRC has announced that UK payroll systems must meet the requirements of both tax systems. Businesses will consequently have to deal with two tax systems since they have or could have employees from both tax jurisdictions.

Will the two tax systems diverge? This seems likely in view of the tax announcements made by most political parties in Scotland. Will the two tax systems increasingly diverge? Possibly, in view of the Scottish Government’s and others’ desire to obtain more devolved tax powers.

Will Revenue Scotland be given responsibility for administering income tax? If the two systems diverge significantly, this would become more likely.

Hyperlinks

Scotland Act (2012)
http://www.legislation.gov.uk/ukpga/2012/11/contents/enacted

Technical guidance
https://www.gov.uk/government/publications/scottish-rate-of-income-tax-technical-guidance-on-scottish-taxpayer-status/scottish-rate-of-income-tax-technical-guidance-on-scottish-taxpayer-status

Fact-sheet
http://www.parliament.scot/FinancialScrutiny/How_income_tax_revenue_will_change_in_Scotland.pdf

Professor David Bell’s report (2015)
http://scotlandseptember18.com/wp-content/uploads/2015/09/One-Year-on-report.pdf

2. Corporation Tax

Currently, the UK has one corporation tax jurisdiction. This would change if corporation tax is devolved to Scotland, with significant implications for companies that trade in Scotland and the rest of the UK (RUK) since they would have to consider the tax implications of their business arrangements. Are they taxable in one tax jurisdiction or both?

Companies need clear guidelines to avoid double taxation, optimise their tax position and reduce business complexity. So a double taxation treaty would have to be agreed between Scotland and RUK to clarify and standardise tax arrangements. This treaty would be based on the model tax convention (MTC) developed by the Organisation for Economic Development and Co-operation (OECD). However, it is likely that revisions would be made to sections of the OECD MTC due to the highly integrated nature of the UK economy, the ease of trading (for SMEs and large companies) across the UK due to the internet and the UK logistics / transport network.

Article 5 of the MTC, which deals with permanent establishment, would be closely scrutinised since it was developed to facilitate trade between two sovereign states, mostly done by larger companies, in the pre-internet world. It was not designed to address the issues that would arise when a country such as the UK is split into two tax jurisdictions.

Under the terms of the OECD MTC, profits are taxable in the country in which it is resident unless it does business in another country through a "permanent establishment": a "fixed place of business through which the business of an enterprise is wholly or partly carried on". This covers a "place of management", "branch", "office", "factory", "workshop", and "mine, an oil or gas well, a quarry or any other place of extraction of natural resources".

So far, it seems quite simple. If you're there, you're taxed there. But it's more complicated than that since the OECD MTC has a number of exclusions. Firstly, a sector exclusion: "a building site or construction or installation project" will only be deemed to be a permanent establishment "if it lasts more than twelve months". Secondly, its definition of what constitutes a "permanent establishment" has number of additional exclusions, such as the use or maintenance of facilities or stock "solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise", or the maintenance of a fixed place of business "solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise".

These exclusions – amongst others – mean that physical presence does not always give rise to tax liability. A company can enter into arrangements that will ensure it is not liable for tax in another country where it does business. However, these exclusions do not apply if the office or an employee in the other country can accept orders from customers based in that country. While this was an issue for companies dealing with the general public, the internet allows businesses to deal directly with customers wherever they are located.

Perhaps a radical overhaul is required in relation to Article 5 to facilitate "economic co-operation and development" across the UK. For example:

- Should companies deemed to have a permanent establishment in another country be given a waiver from Article 5 if their sales are below a specified level in that country?
- Should Article 5 not be applied to SMEs?
- Should sector specific exclusions not be granted?
- Should the legal treatment of internet orders be changed? Websites that display products are "invitations to treat". Acceptance occurs when a confirmatory email is sent to a customer from the country where the order is accepted.

Such questions demonstrate the complexity at hand – and there are no easy answers. Some would see such amendments as increasing the likelihood of tax avoidance. Others would see them as facilitating trade and encouraging economic growth. It is also worth remembering that corporation tax is not the only tax paid by companies.

Countries, quite naturally, want to maximise their tax take to fund public expenditure. However, the negotiation of a Scotland-RUK double taxation treaty should not be about grabbing as much of the cake as you can. That would be short-term view. It should be about developing a treaty that will work to the benefit of Scotland and RUK, today and tomorrow. Evidence must be obtained from SMEs and large companies with cross "border" trade to develop an appropriate treaty and inform tax policy in Scotland and RUK:

- Sales revenue by country
- The extent to which the internet is used for cross "border" trade
- Determine how companies operate on each side of the "border"
- Identify key tax issues: tax rate, capital allowances, transfer pricing, offset of profits and losses, payment etc
- Ascertain potential impact on business arrangements and structures if corporation tax is devolved to Scotland

The devolution of corporation tax to Scotland would have significant implications for companies and trade in Scotland and RUK. However, an evidence-based approach to this issue would enable the development of a mutually beneficial double taxation treaty and appropriate tax policies.

The following articles, published in The Conversation, consider a number of issues in relation to corporation tax and propose an alternative approach to raising revenues from companies.

Transfer pricing
https://theconversation.com/tug-of-war-over-whisky-profits-beckons-if-scotland-gets-corporation-tax-powers-42147

Taxing company sales instead of profits

https://theconversation.com/seven-reasons-why-taxing-company-sales-instead-of-profits-is-a-non-starter-54263

Alternative approach to raising revenues from companies
https://theconversation.com/corporation-tax-the-progressive-case-for-getting-rid-of-it-56452
https://theconversation.com/how-to-ditch-corporation-tax-and-grow-government-income-at-the-same-time-64768

Hyperlinks

Model tax convention
http://www.oecd.org/tax/treaties/2014-model-tax-convention-articles.pdf

Offset of profits and losses
http://www.bbc.co.uk/news/uk-scotland-26864329

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