[redacted [redacted]
Fiscal Responsibility Division
20 February 2018

Cabinet Secretary for Finance and the Constitution

SCOTTISH INCOME TAX – UK INCOME TAX ALLOWANCES AND RELIEFS

Purpose

1. To provide advice on UK Government Ministers' decisions on how UK income tax allowances and reliefs will be applied to Scottish taxpayers to accommodate the Scottish Government's proposed income tax policy changes for 2018/19.

Priority

2. Urgent.

Summary

3. Tax allowances and reliefs that are applied to income tax are a reserved matter. While the Scottish Parliament has the power to set income tax rates and bands for Scottish tax payers, which apply to non-savings non-dividend income, the UK Government retains the power to decide how tax allowances and tax reliefs are applied to Scottish income tax payers.

4. There are a few allowances available to income tax payers that require careful consideration in the context of the proposed Scottish income tax policy for 2018/19: Pensions Relief at Source; **[redacted – out of scope]**~~Marriage Allowance; Gift Aid; Finance Cost; and Deficiency Relief.~~ Details on these allowances and reliefs at Annex A.

5. Mel Stride, Financial Secretary to the Treasury, has responded to your letter of 25 January setting out the UK Government's decision on how these allowances and reliefs will be applied to Scottish taxpayers with the new rates and bands proposed for 2018/19.

6. The UK Government has agreed that:
   - Pensions Relief At Source **[redacted – out of scope]**~~and Gift Aid relief~~ will be available to Scottish tax payers at Scottish income tax marginal rates;
   - ~~**[redacted – out of scope]**Marriage Allowance will be available to all eligible Scottish taxpayers who pay tax at the starter, basic and intermediate rates; and~~
   - ~~Finance cost and deficiency allowances will continue to be available to Scottish tax payers at UK basic rate~~.

7. HMRC expect these measures to be in place in time for the commencement of the new tax year on 6 April, although there is a risk here as timescales are tight for passing the required UK legislation.

Impact for Scottish tax payers

8. In financial terms no Scottish taxpayer will be worse off with regards to the amount of allowances and reliefs they would have received had there been no changes to rates and bands policy. There is a potential increased administrative burden for intermediate rate tax payers, but we are continuing to work with HMRC to minimise this.

Summary of Impact for Scottish tax payers

	Starter (19%)	**Basic (20%)**	**Intermediate (21%)**	**Higher (41%), Additional (Top) (46%)**
Pensions RAS (relief at 20%)	Gain additional 1 percentage point of relief only if claiming through Relief at Source	No impact	Will be able to manually claim additional 1 percentage point of relief – this is the same approach as for higher and additional rate	No impact – will continue to claim additional relief separately
[redacted – out of scope]~~Gift Aid~~	**[redacted – out of scope]~~No impact~~**	**[redacted – out of scope]~~No impact~~**	**[redacted – out of scope]~~Will be able to manually claim additional 1 percentage point of relief – this is the same approach as for higher and additional rate~~**	**[redacted – out of scope]~~No impact – will continue to claim additional relief separately~~**
[redacted – out of scope]~~Marriage Allowance~~	**[redacted – out of scope]~~No impact~~**	**[redacted – out of scope]~~No impact~~**	**[redacted – out of scope]~~No impact – although treated equally with UK may feel that it is unfair that they do not receive relief calculated to match marginal rate~~**	**[redacted – out of scope]~~People earning between £43,400 to £45,000 will not be eligible – this is a continuation of current policy~~**

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			~~(as with Gift Aid and RAS)~~	
[redacted – out of scope]~~**Finance Cost**~~	**[redacted – out of scope]**~~Slight financial benefit~~	**[redacted – out of scope]**~~No impact~~	**[redacted – out of scope]**~~No impact – although treated equally with UK may feel that it is unfair that they do not receive additional relief to match marginal rate (as with Gift Aid and RAS)~~	**[redacted – out of scope]**~~No impact~~
[redacted – out of scope]~~**Deficiency relief**~~	**[redacted – out of scope]**~~No impact~~	**[redacted – out of scope]**~~No impact~~	**[redacted – out of scope]**~~No impact~~	**[redacted – out of scope]**~~People earning between £43,400 to £45,000 (higher rate Scotland) may receive an additional benefit compare to rUK individuals with the same income~~

Communications

9. Despite applying to Scottish taxpayers these issues are reserved in nature and as such the communication of these decisions should be considered in two strands. One strand will be for the SG to communicate the principle that Scottish taxpayers will be no worse off against eligibility in the rest of the UK, although there remains the issues of additional administrative burdens for intermediate rate taxpayers **[redacted – out of scope]**~~and also potentially not receiving Marriage Allowance at marginal rates~~.

10. A draft letter has been prepared for you to send to the Finance and Constitution Committee alerting them to the prepared changes (Annex B).

11. The second strand of communications is one for HMRC in ensuring that Scottish taxpayers are aware of how these proposals will impact on their tax affairs. We have received representations from stakeholders that there is a requirement and appetite for improved guidance. Officials are working with HMRC to ensure that appropriate guidance is provided via the HMRC website.

Recommendation

12. I invite you to:

- **Note the decisions of the UKG, and agree the proposed reply**
- **Agree the proposed letter to the Finance and Constitution Committee**
- **Note that officials will work with HMRC to ensure that appropriate guidance is prepared and published on the HMRC website.**

[redacted [redacted]
Fiscal Responsibility Division
[redacted] [redacted]
20 February 2017

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constit Interest	General Awareness

DG Scottish Exchequer
Director of Financial Strategy
Aidan Grisewood, Fiscal Responsibility Division
[redacted – out of scope [redacted]
~~Responsibility Division~~
[redacted – out of scope [redacted]
~~responsibility Division~~
Callum McCaig, SPAD

Annex A

Background on Taxes Allowances and Reliefs

Pensions Relief at Source (RAS)

1. RAS is currently given automatically to all income taxpayers at the UK basic rate of income tax (20%) through pension providers. For example, if a taxpayer wants to make a £100 contribution to their pension, they only need to pay £80. The scheme administrator reclaims £20 from HMRC and adds this to the scheme to make the total contribution £100. Higher and additional rate taxpayers claim additional relief through HMRC directly.

2. The UK Government has agreed that, with the introduction of the starter and intermediate rates, pension providers will continue to claim relief at the UK basic rate (20%) for all income taxpayers. Scottish taxpayers in the intermediate tax band (21%) can claim additional relief in the same way as higher and additional income tax payers.

3. For income tax payers paying at the starter rate and claiming pensions relief through a salary sacrifice scheme, pensions relief will be at the marginal rate (19%). Scottish income tax payers, at the starter rate, claiming pensions relief through Relief at Source will benefit from relief at 20% rate, as administration costs are disproportionately high to reclaim the 1% additional relief they are getting.

Issues for taxpayers

4. **Starting rate:** This approach will mean that those paying tax at the starter rate will benefit slightly, gaining an additional 1 percentage point of relief. If these taxpayers received RAS at a rate to match their marginal rate of tax then, if they wanted to make a contribution into their pension of £100, they would have to pay £81 rather than £80.

5. **Basic rate:** There will be no change for basic rate taxpayers.

6. **Intermediate rate:** Intermediate rate taxpayers will need to make a separate claim to receive their full relief. The approach for those paying tax at the intermediate rate is consistent with the treatment of the higher and top rates of tax, however intermediate taxpayers are likely to have previously been basic rate taxpayers and may find this additional step more burdensome since they are not familiar with the process.. HMRC are considering an approach that would automatically provide the additional 1 percentage point of pensions relief, but this would not be available for 2018/19 and would come at an additional cost to the SG.

7. **Higher and Additional (Top) rate:** Scottish taxpayers in the higher and additional rate bands will continue to claim relief as before, at the Scottish rates.

8. Note: Pension contributions that are made on a “net pay” basis, deducted from salary before tax is applied, will not be affected by Scottish income tax policy and will continue to operate as it currently does for taxpayers at all rates.

[redacted – out of scope]~~Gift Aid~~

~~9. For charities there will be no change to Gift Aid. They will continue to claim an additional 25% on eligible donations received (representing the sum donated grossed up by the UK basic rate of 20%) on donations from UK taxpayers. We have not received any representations from the charitable sector that any changes should be made and we anticipate that they will be content with this approach.~~

~~10. Higher and additional rate taxpayers can claim tax relief that effectively increases their higher and additional rate thresholds by the value of the grossed up donation and this mechanism will also apply to intermediate taxpayers (21% rate). The UK Government has agreed that there will be no impact for people in the starter rate band (19%); charities will continue to receive Gift Aid based on the UK basic rate from starter rate taxpayers.~~

~~11. This approach will ensure that there is no impact on charities compared to the current process. Individuals paying tax at the starter rate will be unaffected (the Charity benefits rather than the individual), basic rate taxpayers will be unaffected, and intermediate rate taxpayers will face a small administrative burden to reclaim the extra 1 percentage point of relief.~~

~~Marriage Allowance~~

~~12. Marriage Allowance enables a taxpayer to transfer 10% of their unused personal allowance to their spouse or civil partner if certain conditions are met, including the requirement that the recipient partner’s tax liability is within basic rate. The UK Government has confirmed that Scottish taxpayers who fall into the starter, Scottish basic and intermediate rates will continue to be eligible for Marriage Allowance.~~

~~13. The available allowance will be calculated by reference to the UK basic rate (currently 20%). This means that all eligible Scottish taxpayers in 2018/19 will enjoy a maximum tax reduction of £240 (10% of £11,850 multiplied by the basic rate of 20% and rounded up to the nearest £10), which is the same as the maximum amount available to taxpayers elsewhere in the UK.~~

~~14. If the allowance were calculated according to an individual’s own marginal rate of tax, rather than the UK basic rate, then starting rate taxpayers would receive £230 and intermediate rate taxpayers would receive £250. Starter rate taxpayers therefore benefit from the use of the UK rate but intermediate taxpayers may feel that they are slightly disadvantaged. Whilst no Scottish taxpayer who earns less than the Scottish higher rate will receive less than an rUK counterpart, an argument could be levelled that intermediate rate tax payers will receive less relief than they could be entitled to.~~

~~15. Scottish higher rate taxpayers will continue to be excluded from claiming Marriage Allowance even if they earn less than the UK higher rate threshold. This means that Scottish taxpayers who earn between £43,430 and £45,000 will be worse off than those earning an equivalent sum elsewhere in the UK. This is also the position in 2017/18.~~

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~~Finance Cost allowance~~

16. ~~Relief for landlords will continue to be paid at a flat 20% rate (to which the reducer will be applied). This is similar to marriage allowance in that it is a flat rate allowance rather than at the marginal rate. The UK Government has changed the way in which finance costs (primarily loan interest) can be used to reduce tax liabilities for landlords. In previous tax years, these expenses were deductible in full when computing a profit figure. This has now been restricted and replaced with a tax reducer relief that is calculated based on 20% (i.e. the UK basic rate) of the lower of the loan interest for the year, the property income for the year and the individual's taxable income for the year. The full impact is being tapered over four years, so in 2018/19, taxpayers will be entitled to deduct 50% of their loan interest and the remaining 50% is relieved in the form of the tax reducer. By 2020/21, only the tax reducer will be available and finance costs will not be allowable deductions. The amount of Income Tax relief landlords can get on residential property finance costs is being restricted to the basic rate of tax, and will be introduced gradually over 4 years from April 2017.~~

17. ~~HMRC's proposal makes administrative sense. It will ensure that the computation is minimally complex for taxpayers and will ensure parity with landlords resident elsewhere in the UK. However, this may result in presentational challenges in the context of other recent policy developments that may be perceived as detrimental to landlords in Scotland (particularly the end of the short assured tenancy). This tax interaction has the potential to be misconstrued as part of a package of "anti-landlord" measures, despite the fact that it is a reserved matter. It is important that communications emphasise that Scottish taxpayers will not be worse off, in terms of the relief, than rUK taxpayers.~~

18. ~~**Impact:**~~
    - ~~Starting rate taxpayers: minor potential benefit~~
    - ~~Scottish basic rate taxpayers: no impact~~
    - ~~Scottish intermediate rate taxpayers: treated equally with UK but may feel that it is unfair that they do not receive additional relief to match marginal rate~~
    - ~~Scottish higher and top rate taxpayers: No impact – restrictions will be uniform for all taxpayers~~

~~Deficiency relief~~

19. ~~A special relief called 'deficiency relief' may be available to individuals where a policy or contract (for example life assurance) comes to an end and the final capital sum equates to less than annual payments made.~~

20. ~~This relief will be adapted by HMRC for Scottish income tax purposes, in a similar way to Gift Aid relief, although it is estimated that there were only around 12 Scottish claims for this relief last year.~~

21. ~~Worked examples on the allowances and reliefs can be provided.~~

Cabinet Secretary for Finance and the Constitution
Derek Mackay MSP

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[redacted]
[redacted]
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

25 January 2018

Dear [redacted]

In my draft budget for 2018/19 I proposed a new income tax policy for Scotland. This proposal seeks to raise additional revenue, whilst delivering greater fairness. It does so by using the Scotland Act 2016 income tax powers to introduce two new tax bands, as well as changing the rates of two existing bands.

The partial devolution of income tax powers and separation of responsibility for collection of Scottish income tax creates some areas where the Scottish Parliament, in exercising its powers, creates some potential consequences for eligibility for reliefs and associated potential administrative burdens for taxpayers. In particular, the draft budget income tax policy proposal would, as current legislation stands, [redacted – out of scope] [redacted – out of scope] and administrative questions have been raised over the application of pensions relief at sourc [redacted – out of scope]

Our respective officials have engaged constructively on these matters in anticipation of changes in income tax policy and noted potential consequences in the production of the Scottish Government's discussion paper "The Role of Income Tax in Scotland". There has also been good engagement with stakeholders on these issues both before and after publication of the draft budget.

Despite this good work, there is understandably still some external uncertainty on administrative issues. I therefore welcome your quick clarification of the UK Government's position on [redacted – out of scope] [redacted – out of scope] [redacted – out of scope] I would also welcome your commitment to making similar progress with the issue of applying pensions relief for these same taxpayers. In addition to pensions relief, I recognise that there is also potential work to be done on applying [redacted – out of scope] [redacted – out of scope]

We all have the same aim of making devolution work, and I again welcome the engagement between our officials in achieving this. Once the changes have been made to ensure that our income tax policy proposal for 2018-19 can be delivered in an effective manner, I would value further engagement between our officials to ensure that we can be prepared for any future income tax policy changes should they be needed.

DEREK MACKAY

Summary: SFC Model Provision and Round 0 Forecasts

- [redacted – out of scope].
- In the joint income tax working group, we also asked the SFC to amend their modelling of pension relief and the associated excess relief charge which applies if taxpayers exceed their annual allowance. This is to reflect the agreement struck with HMRC earlier this year according to which any excess contributions would incur a "charge" to be paid at the top marginal rate in Scotland rather than the rUK rate. This has not been incorporated yet as the model still assumes that the tax charge is based on marginal rates in the rUK and no changes have been made to the off model adjustments.
- [redacted – out of scope]

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20 February 2018

Dear [redacted]

Thank you for your letter of 19 February 2018 setting out the UK Government's approach on how income tax allowances and reliefs will be applied to Scottish taxpayers with the new rates and bands proposed for 2018/19.

I appreciate your assurance that the current income tax allowances and reliefs will continue to be available to Scottish taxpayers, and your commitment to have necessary legislation in place as close to the start of the tax year as possible.

Our respective officials are continuing to engage constructively on the implications of the proposed income tax changes and I hope will continue to work together on the implementation of income tax allowances and reliefs to be applied to Scottish tax payers.

Yours

DEREK MACKAY

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