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Briefing note

Scottish rate of income tax and pension tax relief

The Scotland Act 2012 gives the Scottish Parliament the power to set the Scottish rate of income tax. As a result, since 6 April 2016, Scottish taxpayers have been subject to lower rates of UK income tax. However, they are also subject to the additional Scottish rate of income tax (SRIT), money collected from which goes to the Scottish Government.

> From the 2017/18 tax year, the overall income tax paid by some Scottish taxpayers will differ to that paid by equivalent counterparts in the rest of the UK.

Why is this relevant for the 2017/18 tax year?

From the 2017/18 tax year, the overall income tax paid by some Scottish taxpayers will differ to that paid by equivalent counterparts in the rest of the UK.

For the 2017/18 tax year, the UK Government has increased the higher rate income tax threshold from £43,000 to £45,000. The Scottish Government, however, has maintained the threshold at £43,000.

Overall basic, higher and additional rates of income tax have been maintained at 20%, 40% and 45% respectively for all UK taxpayers.

This means Scottish taxpayers with income above £43,000 will now pay a higher amount of overall income tax than equivalent counterparts in the rest of the UK (on income above £43,000 and up to £45,000).

This briefing note provides further explanation in the context of pension contribution tax relief. Employers and pension scheme trustees may wish to review their member communications.

How does it work?

Scottish taxpayers are subject to UK income tax at 10% lower than the full UK rates. In addition, they are subject to the SRIT set by the Scottish Government, which HMRC administers as part of the UK income tax system. Scottish taxpayers have a PAYE tax code beginning with the letter 'S'.

For tax year 2016/17, the SRIT was set at 10%, with the personal allowance and tax band thresholds the same for all UK taxpayers. This meant Scottish taxpayers paid the same overall income tax as taxpayers in the rest of the UK for the tax year 2016/17, whether they paid the basic, higher or additional rates.

From the tax year 2017/18, the Scottish Government has additional powers to vary the SRIT by band, introduce new bands and vary the thresholds between bands. It is not permitted to vary the personal allowance. The Scottish Government exercised its powers by maintaining the higher rate of income tax threshold at £43,000, rather than following the UK Government in increasing the threshold to £45,000.

The SRIT applies to employment, pension and rental income. It does not apply to savings or dividend income, so UK rates continue to apply to income from these sources. National Insurance contributions are not affected by SRIT.

A person is classed as a Scottish taxpayer by their residency status rather than their nationality or where they work. Essentially, someone is a Scottish taxpayer if their sole or main residence is in Scotland.

Example comparison

Stuart lives in Edinburgh and is a Scottish taxpayer. His income is £48,000 in tax year 2017/18 and his tax code is S1150L. David lives in Leeds and his income is also £48,000 in tax year 2017/18. His tax code is 1150L.

The income tax payable by each, which HMRC collects through PAYE is as follows:

	STUART	DAVID
Personal allowance	£11,500	£11,500
Income subject to basic rate tax	£31,500	£33,500
Income subject to higher rate tax	£5,000	£3,000
PAYE income	**£48,000**	**£48,000**
Basic rate income tax payable at 20%	£6,300	£6,700
Higher rate income tax payable at 40%	£2,000	£1,200
Total income tax payable	**£8,300**	**£7,900**

Who is a Scottish taxpayer?

Firstly, a person must be UK resident for tax purposes in order to be a Scottish taxpayer. In other words, if someone is not UK tax resident then they cannot be a Scottish taxpayer.

A person is classed as a Scottish taxpayer by their residency status rather than their nationality or where they work. Essentially, someone is a Scottish taxpayer if their sole or main residence is in Scotland.

A UK resident will either be classed as a Scottish taxpayer or a UK taxpayer for a complete tax year – there cannot be a situation where someone is treated as a Scottish taxpayer for part of a year.

For most taxpayers, the location where they live will be obvious, but there will be less straightforward cases – for example, where people have more than one home, or have moved into or out of Scotland during the tax year.

HMRC identifies who is a Scottish taxpayer, and gives them a PAYE tax code beginning with the letter 'S'. Employers and pension providers should only use a Scottish tax code if HMRC tells them to do so.

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> Taxpayers who complete a self-assessment tax return will be asked to confirm whether they are a Scottish taxpayer in their 2016/17 return.

How does HMRC identify Scottish taxpayers?

HMRC wrote to individuals who they believed to be Scottish taxpayers in December 2015. At the same time, it also carried out a publicity campaign throughout the UK to raise awareness of the SRIT and to urge people whose main residence is in Scotland to contact them if they had not received a letter from HMRC.

Taxpayers who complete a self-assessment tax return will be asked to confirm whether they are a Scottish taxpayer in their 2016/17 return.

There will be situations where determining residency status may not be straightforward. HMRC's technical guidance includes a number of examples: www.gov.uk/guidance/work-out-if-youll-pay-the-scottish-rate-of-income-tax. Where someone has moved between Scotland and the rest of the UK during a tax year, taxpayer status will be based on the length of time spent in Scotland or the rest of the UK.

What about tax relief on pension contributions?

There are two main ways of giving tax relief on employee pension contributions, which affect how tax relief is obtained.

Net pay - for occupational (trust-based) pension schemes, tax relief on personal contributions is given using the 'net pay' method. Gross contributions are deducted from gross (pre-tax) pay, meaning that employees pay the correct amount of income tax through PAYE, whether or not they are identified as Scottish taxpayers through their PAYE tax code.

For any personal contributions not made through PAYE (e.g. for one-off contributions), taxpayers (Scottish or otherwise) should make a claim to HMRC for the tax relief due.

Relief at source - for personal pensions and some master trust schemes, personal contributions are paid using the 'relief at source' method. Contributions net of basic rate tax relief are deducted from net (post-tax) pay, with pension providers claiming basic rate tax relief directly from HMRC to add into the pension scheme. Higher and additional rate taxpayers can claim additional tax relief separately through their self-assessment tax return.

Changes to systems and processes for collecting pension contributions via the 'relief at source' method will be put in place from 6 April 2018, so that pension providers can collect overall basic rate tax relief at the appropriate rate, depending on whether an individual is a Scottish taxpayer or a UK taxpayer. As employers deduct contributions net of basic rate tax, should the overall basic rates of tax differ in future tax years between Scottish taxpayers and taxpayers in the rest of the UK, then this will also need to be recognised in employers' payroll processes.

What about pension salary exchange?

Another way of employees making pension contributions is through salary exchange. Under this process, employees contractually exchange salary equivalent to their pension payments and the exchanged salary is then made as additional employer contributions. This is an efficient method of paying in, as neither the employees nor the employer pay National Insurance on the salary exchanged.

There is of course no income tax on the salary exchanged. Although tax and tax relief will work in a different way to the employee contribution methods above (and the timing can sometimes differ), the overall effect will normally be neutral.

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For more information visit www.gov.uk/scottish-rate-income-tax.

Potential opportunity for Scottish taxpayers?

For the tax year 2017/18, higher rate Scottish taxpayers will normally pay a higher amount of overall income tax than equivalent counterparts in the rest of the UK. However, those Scottish taxpayers whose income net of pension contributions is £43,000 or less will, through higher rate tax relief on income between £43,000 and £45,000, pay the same overall income tax as equivalent counterparts in the rest of the UK.

This may be a viable option for some higher rate Scottish taxpayers, e.g. those with income above but not substantially in excess of £43,000, and of course recognising factors such as the affordability of contributions and the Annual and Lifetime Allowances.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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