

Private and Confidential

A Fairer Local Tax
(CRE 959),
CSU, Spur U5b,
Saughton House,
Broomhouse Drive,
Edinburgh
EH11 3XD.

11 July 2008

Our ref: TAX/ED20/VJS
Your ref: TAX/ED20/RI/VJS

Dear Sirs

A Fairer Local Income Tax

We have pleasure in enclosing our response to the above consultation paper.

Yours faithfully

Rhona Irving
Partner
Tax

A Fairer Local tax for Scotland

Response to consultation from PricewaterhouseCoopers, Scotland

PricewaterhouseCoopers is pleased to be able to participate in the consultation on the proposals for a local income tax in Scotland. Our principle interest in responding to this document is the impact the proposals will have on our clients being predominantly businesses and private individuals operating in Scotland and for that reason we have limited our response to those questions which directly relate to these issues. We accept that there are some benefits to a local tax in Scotland, as identified in the consultation paper. However, for the reasons identified below, we consider that there are significant risks in adopting this approach at this time.

Q1 – In your view, should the local income tax personal allowance be the same, higher or lower than the UK income tax personal allowance?

Personal allowances are the level of income which a taxpayer can receive before becoming liable to pay income tax. Under the UK national tax system each individual, regardless of age or sex, is entitled to a basic allowance but higher allowances are available to individuals with particular circumstances. The main additional allowances are given to individuals aged over 65 (with an even higher allowance at age 75) whose income is below £20,900 with the extra allowance being clawed back at the rate of £1 for every £2 of income down to the level of the basic allowance for those whose income exceeds that threshold. Other allowances include an allowance for those who are registered blind and a married couple's allowance at various rates (also available to civil partners) where one of the couple is born before 6 April 1935. Non domiciled individuals taxed on a remittance basis have no personal allowance at a national level.

We consider that if the personal allowance for the local income tax differed from the national personal allowances this would introduce considerable complexity and confusion into the tax system and make collection of the tax more difficult and expensive.

Income tax from employed earners and pensioners is collected primarily through the PAYE system. Central to that system is the operation of a Notice of Coding which grants these allowances. If the allowances were to differ from those applicable to national taxation a mechanism would have to be found which would adjust that notice of coding to allow a local income tax at 3% to be applied to a different amount of income than that subject to national tax.

Using simple figures to illustrate this, a pensioner with income of £20,000 and a age related personal allowance of £7,500 would need to have tax at 20% collected on income of £12,500 at a national level, i.e. £2,500. If the allowance was restricted to a basic allowance of £5,000 for local income tax purposes additional income tax of 3% would have to be collected on £15,000 i.e. £450. The mechanism might involve appending a suffix to the code which invoked the application of a table charging income tax at 23% instead of 20%. However to collect the correct total amount of tax due of £2,950, the allowances in the coding would have to be adjusted to £7,174. Thus PAYE would apply to income of £20,000 less allowances of £7,174, = being £12,826 at 23% = £2,950.

It can readily be seen from this simplified example that the Code would include an allowance which bears no obvious relation to either the national or Scottish personal allowance and most taxpayers would find this confusing and not readily understandable. It would be difficult to calculate the adjustment and when taking into the account that many taxpayers have more than one pension or source of earnings and that higher rate tax may apply, the complexities created by differential allowances may well be insuperable. Undoubtedly there would be a high level of cases where PAYE failed to deduct the correct tax at source resulting in an

increased level of taxpayers having to file self assessment tax returns after the end of the tax year to correct any tax over or under deducted.

The consequence of this is that we would expect collection costs to be high and the imposition of a local income tax to have an upward impact on existing national tax collection costs as well.

For these reasons we consider that no differential personal allowances should be applied to the local income tax.

Q2- Do you think a flat rate of 3% is too high, too low or about right?

The population of Scotland is estimated to be 5.116m, but of this number only 2.68m are taxpayers of which 0.4m pay tax at rates below the basic rate (*Source: Survey of Personal Incomes 2005/06*). The average median earnings of a Scots worker are just under £23,000 (Appendix 1) but this disguises a wide differential between employed earners, the self employed and pensioners. The Council tax billed for the year to 31 March 2007 was £1,866m (*Source: The Scottish Government Council Tax Collection Statistics to 31 March 2007*). The Barnett formula drives the block grant which funds Scottish expenditure and included in that is a sum of £400m which funds Council tax benefit.

In Appendix 2 we set out an estimate of the total tax which might be raised by an uncapped 3% local income tax on Scottish taxpayers. This suggests that a range of between £1.111m and £1.879 might be raised by the LIT. Taking the mid-point of this range of £1.495m there would be a funding gap of £371m still to be filled. This is just under the Council tax rebate funded to local councils in Scotland by central government.

We believe that a 3% rate may only be marginally enough and on a worst case scenario inadequate to match the current sums raised by Council tax. The Lyons Inquiry into Local Government concluded that to replace council tax completely would require a local income tax of 7.7p in the pound. We are of the view that further research is required to reconcile the disparity between these figures in a Scottish context and to establish if 3p is enough to fund local services.

Q3 Would you be inclined to pay more Local Income tax to provide for better quality local services.

This question is appropriate to a response from an individual on a personal subjective basis and hence it is not appropriate that we answer it. We observe however that while a local income tax collects taxes based on ability to pay, it does not match taxation to the use of these services and hence may be observed as introducing unfairness at a different level to the system.

Q4 Do you believe the level should be set locally or nationally?

For reasons explained elsewhere in this response we believe a series of rates set locally by different Councils would be difficult to administer and collect as well as expensive to operate and is not a practical proposition. There would be difficulties identifying the jurisdiction applicable to taxpayers and in resolving conflicts of jurisdiction. Difficulties for employers operating tax collection processes would be magnified. It would encourage behavioural changes, e.g. if Fife charged a 3% rate and Edinburgh City Council 4%, more people would buy homes in Fife and commute to work in Edinburgh. Employers would have incentives to locate their business in Fife. For example a business with a £1m wage bill would know it could save its work force 1% or £100,000 by locating and recruiting in Fife.

Question 5 - Among the following, which should or should not be taxed as part of Local Income Tax?

- **Earned Income / Wages?** **Yes** **No** **Don't Know**
- **Income from Pensions?** **Yes** **No** **Don't Know**
- **Income from Savings?** **Yes** **No** **Don't Know**
- **Income from Financial Investments?** **Yes** **No** **Don't Know**
- **Income from Second Homes?** **Yes** **No** **Don't Know**

The consultation paper proposes there should be no other exemptions or discounts other than the personal allowance from the LIT. It is far from clear how this proposal could work in practice. For example, would income not currently liable to income tax due to contributions to pension schemes be taxable? Many employees will be unaware how much pension contribution is made on their behalf by employers as national income tax exemptions exclude this from an income tax charge. Would this exclude deductions for the self employed who incur losses? Would there be relief for charitable donations? Would the local income tax extend to non cash earnings such as company cars, store vouchers or share scheme benefits? Would share schemes which benefit from exemptions or capital gains tax treatment be subject to the local income tax and how would this be measured? (SAYE schemes or EMI schemes are examples).

The prospect that income subject to the local income tax could be radically different from income subject to a national income tax introduces extensive potential complications to the tax system and there would require to be extensive new legislation included in tax law relevant to the local income tax to accommodate the proposal there should be no discounts or exemptions beyond the personal allowance for the LIT. A differential system opens up the prospect of a significant number of misunderstandings and misinterpretation of the law as taxpayers and employers struggle to reconcile two different tax systems applying simultaneously.

It is the practice of H M Revenue and Customs to “code out” investment income up to £10,000 in Notices of Coding and as such income would not be subject to an LIT, this would represent a further adjustment required to the operation of PAYE.

Not everyone lives off earnings. An individual who may be very wealthy but whose total income was derived from savings and dividend income would not pay any local income tax based on the proposal.

In the case of a family or privately owned business or partnership there is scope for manipulation. A couple who were able to control the split of remuneration could generate local income tax savings as could owners of companies who could reduce earned income and take higher reward by way of dividend. There are already drivers to this effect as income tax rates on dividends are lower and they do not attract national insurance but the increased basic tax rate will widen the differential. Current changes to small companies’ rate of corporation tax have partly been driven by a desire to remove any tax incentive to incorporate.

We also have concerns that switching to an income based tax would result in self employed individuals who participate in the “black economy” or who under declare their earnings paying no contribution at all to local services. Under the Council tax regime such avoidance is more difficult.

Q6 In your view, do you think that there should be any special exemptions or discounts from local income tax.

In our view, to facilitate collection of the tax it would be essential that taxable earned income for local income tax purposes was calculated identically to the calculation of income subject to national income tax.

Q7 Do you agree that a Scottish taxpayer should be defined using the definition already contained in the Scotland Act.

There are two elements to the “Scottish taxpayer” test:

(a) UK residence; and

(b) closest connection to Scotland. Scottish MPs, Scottish MEPs and members of the Scottish Parliament are all automatically determined to meet the closest connection test.

To be liable to the increased income tax rate an individual would have to be resident in the UK for income tax purposes. One of the recent complaints about the changes to the tax rules for non domiciled and non resident individuals is that the UK lacks a single rule which determines tax residence. In broad terms anyone who spends more than 183 days per year in any part of the UK is UK resident. Thereafter the rules vary according to whether the taxpayer is an emigrant coming to the UK or whether the taxpayer has lived in the UK for a long period of time and then leaves the UK. Those coming to the UK are resident if they spend more than an average of 90 days per tax year ending on 5 April averaged over a rolling four year period. For those who have already acquired UK residence, losing it is a little harder but generally the same measure will apply of a 90 day average measured over a four year rolling period. Anyone who goes overseas to take up full time employment loses UK residence much quicker and will be non resident from date of departure – the same applies in reverse to anyone coming to the UK to take up full time employment.

Owning residential property in the UK can complicate the determination of residence and, for most of the 20th century, even setting foot in the UK was enough to deem an individual to be UK resident if accommodation was available for their use. More recently, available accommodation is ignored in the case of individuals working full time abroad and visitors to the UK who come for a temporary purpose only. Those in other categories still need to pay attention to available accommodation which can result in residence rulings applying where visits to the UK are much shorter than 90 days.

Prior to 6 April 2008, in determining UK residence days of arrival or departure were ignored. Post 6 April 2008, days of UK residence have been brought into line with the Scotland Act in that a day of presence is determined if the individual is present in Scotland at midnight. However, the UK test of residence excludes days spent in the UK in transit except where the individual engages in business and other activities not related to travelling. While Scotland is not a significant transit changeover location, it is conceivable that the mismatch of these rules could result in an individual having to count more days spent in Scotland for local income tax purposes than count for the purpose of determining residence for UK tax purposes. This anomaly is unlikely to have widespread application.

The vast majority of taxpayers will have little difficulty in knowing if they are UK resident and if there are any issues in determining this it will be determined at the wider UK level rather than just at a Scottish level. However, it will be harder for individuals to decide on the second test which is that Scotland is the part of the United Kingdom with which the taxpayer has the closest connection during the tax year.

The easiest test to apply is a day count test. If the taxpayer is in Scotland at the end of a day at midnight he spends a day in Scotland. Counting up all the days spent in Scotland and all the days spent elsewhere in the UK, if the number of days spent in Scotland exceeds the number of days spent elsewhere in the UK then the taxpayer has the closest connection with Scotland. While conceptually this test is easy, in practice it could be both difficult to apply and verify and anomalous in its operation.

The difficulty in applying it relates to those who have an itinerant lifestyle. Lorry drivers, bus drivers, airline pilots, train drivers, commercial salesmen, seamen and fishermen, and North Sea oil workers are among the obvious list of individuals who might spend long periods in different parts of the UK. Less obvious, but just as numerous, are the many people who drive, fly or commute to different parts of the UK on behalf of their employer or because they are

self employed and/or cover a large geographical area in their work. Office workers, engineers, trainers of various descriptions, sportsmen and entertainers all fall into this category. Currently visitors to and individuals leaving the UK must record their whereabouts for the purpose of establishing UK residence and this is often a burdensome requirement. The reality is that it will be even harder for itinerant Scottish taxpayers to retain records of their whereabouts sufficient to act as evidence in relation to their tax liability. Whereas the UK's geography as an island means that transport outwith the geographical boundaries of the country are easily evidenced through travel tickets, passport entries, visas etc, internally, car journeys carry no evidence, train tickets are often bought with cash and even diary entries will not necessarily prove where the taxpayer spent the night at midnight – Carlisle is after all less than two hours travel from the central belt of Scotland where the bulk of the population live and at the other side of the country Berwick lies on the border.

Anomalies can be forecast from the fact that the test relates only to Scotland versus the rest of the UK and not the rest of the world. So a businessman who spends 95 days in Edinburgh, 90 days in London and 180 days in Paris will spend more days in Scotland than in the rest of the UK and so will have his closest connection with Scotland and be liable to pay the local income tax, notwithstanding 270 days are spent outwith Scotland. This example also illustrates that there could be difficulties with international taxation. It is easily possible for such an individual to be tax resident in both the UK and in France. In that situation where the UK has negotiated a tax treaty with another country the terms of that treaty dictate which country has the taxing right and how much credit is given for tax paid in the other country. Would a local income tax be eligible for credit? Most countries do not include local taxes in creditable taxes and council tax does not currently feature in double tax relief calculations. Would the UK have to renegotiate all its double tax treaties to take account of the position under a local income tax regime?

An individual who emigrated from Scotland on 31 October in a tax year would be regarded as a Scottish taxpayer for the whole tax year. As a result his earnings for the part of the year after 31 October would still be subject to the local income tax even though he did not benefit from Council services after 31 October. If he moved to a country outwith the UK how would collection of a local income tax be enforced?

The most difficult test to apply in relation to the "closest connection" requirement is the principal UK home test. This test is, however, the one which is likeliest to bring most Scots into the local income tax net. For this test to apply the individual has to be present in Scotland on at least one night during the tax year. For at least part of the time spent in Scotland his principal UK home must be located in Scotland and the individual must make use of it as a place of residence. People do move home and the rule caters for a move south or north of the border part way through a tax year by providing that if the times in the year when the principal UK home is located in Scotland comprise at least as much of that year as the times when the location of the principal UK home is not in Scotland then his closest connection will be Scotland.

The chief candidates for difficulty in applying this rule are those with more than one home. Take a businessman who works in London, living in a flat during the week, but commutes home to his wife and children every weekend in Scotland. Which is his main place of residence? Is it determined by the 5 days a week he spends in London or by the two he spends in Scotland? Is it determined by the address he puts on his bank accounts, tax return and sports club memberships? What criteria will determine the location of the principal UK home? There is a similar issue existing in UK tax legislation at present which relates to the capital gains tax exemption which applies when the principal private residence is sold. However the tax rules here are significantly different in that if there are two homes the tax payer can elect which is his principal residence and if he does not the tax inspector decides on the basis of the facts. There are no such tiebreaker rules in the Scotland Act to make it easy to decide nor will the tax office have the last word. Another example of the difficulty of applying this rule would be North Sea Oil workers who work a number of weeks offshore and then return home for extend

If the day count rule or the principal home rule applies then the individual is a Scottish taxpayer who will be liable to pay the local income tax. The operation of these rules is such that it appears a taxpayer would either be a Scottish taxpayer for the whole of the year or not at all. Unlike the rules for national income tax there appears to be no scope for applying concessional split year treatment in the year of arrival or departure.

Q8 In your view should transitional arrangements for individuals apply?

We do not believe a general answer to this question is possible at this stage of development of the idea. Transitional arrangements would be appropriate where undue hardship would result, where individuals might end up paying twice or where the practical measures needed to introduce the new system would result in major disruption if phased in at one time. This might apply to software developments required to implement tax changes for example. We do not believe that a closed approach to transitional measures is helpful until full details are worked out.

Section 2 How will Local income Tax be collected and administered

Question 9 - Which of the following do you think should collect a Local Income Tax?

- **Her Majesty's Revenue and Customs (HMRC)?**
- **A Scottish Government collection agency?**
- **A private sector collection agency?**
- **Local authorities?**
- **Don't Know**
-

Question 10 - Do you think local income tax should be collected at source or through payment?

- **Collected at source**
- **Collected through payment**
- **A combination of collection at source and by payment**
- **Don't know**

Question 11 – If the Government were to offer support to employers to implement these proposals, which would be the most appropriate medium of support in your view?

We answer questions 9 to 11 together as follows:

For HMRC the introduction of a local income tax in Scotland would require the following steps:

1. Identify Scottish taxpayers;
2. Identify income to which the local income tax applies;
3. Collect the tax and maintain a record of how much is collected;
4. Pay the tax into the Scottish Consolidated Fund;
5. Police adherence with the system by taxpayers.

The UK tax system for individuals is a system of self-assessment and for the most part it would be incumbent on Scottish taxpayers to identify themselves on their tax return. Not all taxpayers complete tax returns annually – indeed most employees are taxed under the PAYE system and don't complete a tax return from one year to the next. However, everybody whose tax is not fully collected under the PAYE system has a duty to tell HMRC that they have underpaid tax in which case they are asked to complete a tax return. It follows that the

system is already in place whereby Scottish taxpayers would report to HMRC that they were due to pay an extra 3% on the basic rate of tax. Of course the reality is that in advance of the year of introduction of a local income tax, HMRC would probably bring in a simplified system of notification enabling them to apply PAYE from day 1 in a way that included the extra tax.

The first difficulty for HMRC would be policing the system. Some taxpayers may not be honest about whether they are Scottish taxpayers and some, for the reasons set out above, might make a mistake in deciding that for themselves. For the same reasons that taxpayers might have trouble finding evidence of their movements so would HMRC- but electoral rolls, telephone directories and various other public records of residence might well be a good starting point in enforcing the rules by investigating those cases where a wrong declaration of residence was made. The current system of fines, penalties and interest on unpaid tax would presumably apply equally to the local income tax and should be incentive enough to ensure an adequate level of compliance.

The self employed would be the most straightforward to tax as the full details of taxable income would be declared on their annual tax return and it might be as simple as ticking a box on the tax return for this group to identify themselves. Undoubtedly there are some self employed individuals who do not declare their tax liability but the black economy is nothing new and is already policed. The higher the tax charge, the more incentive there is to under declare income so it is possible a local income tax might aggravate the problem of the black economy.

Employees present the biggest challenge for HMRC, together with adapting the PAYE system to accommodate the variable rate of basic rate tax. PAYE is one of the cleverest inventions in any tax system anywhere in the world. It works as follows:

- Each individual receives a tax code which determines the level of tax free allowances or taxable additions to be made to his or her cash salary;
- The employer applies the tax code through his payroll system and a system of tax tables works out the correct level of income tax to be deducted monthly (or at other intervals) from the remuneration paid;
- The employer deducts and pays over this tax to HMRC and pays the employee his remuneration net of tax;
- If the Notice of Coding is correct the employee will have paid the correct income tax but if it is incorrect the employee should self assess his tax liability in a tax return to correct any under or over payment.

The difficulties are more likely to be internal to the systems used by HMRC which are far from perfect in their current state. Their software which is applied to processing tax returns would need to be capable of applying an alternative rate of basic rate tax or a surcharge on Scottish taxpayers and in identifying exactly how much tax was due to be paid to the Scottish Government. Again that is far from an insuperable adaptation to the software already in existence if there is a will to make the changes. However feasibility studies would be required to ascertain the extent and cost of the changes required, and it is possible the cost could be significant. If the changes are extended to higher rate taxes as proposed, the volume of software changes will inevitably be more extensive.

It can also be foreseen that more anomalies will emerge from the implementation of a local income tax which the system would have to accommodate e.g. top slicing relief.

The role of the employer and new administrative burdens presented by the tax

This has UK national implications as many companies and other organisations have workforces based throughout the UK and may have administrative headquarters in different places to where employees are based.

Payroll software changes could be the biggest burden faced by employers – indeed individuals who buy software to calculate their personal tax bills might find a paucity of suppliers of software suitable for working out the tax bills of Scottish taxpayers if software houses did not see the 5 million or so Scots as a big enough market for their product. As not all software supplied by HMRC online meets all requirements, this has implications for the requirement of Scots taxpayers to efile their tax returns unless they file a paper return by 31 October. Presumably the reason that HMRC currently do not meet all the requirements for online filing is the cost of developing suitable software adjustments and unless full investment was made by the UK Government there could be very real problems for Scottish taxpayers.

It is likely that the cost of developing software changes would be high in relation to the local income tax and that the costs would be passed on to employers by the software houses charging higher prices, or by payroll bureaux charging higher rates.

The onus for determining who should pay tax does not fall on employers. Employers are simply required to apply PAYE according to the instructions issued by HMRC. The question of liability in relation to the local income tax would be strictly a matter for HMRC and the individual and as long as the employer applied the correct Notice of Coding as issued by HMRC that would be an end of his responsibility. As long as the PAYE system was suitably adapted it would not matter if the employer was based in Penzance or Wick nor would it matter where the employee was based, nor where the payroll was operated.

The PAYE system is implemented by the UK national tax system as part of HMRC's mechanism for the collection and management of tax. It follows that if a local income tax is applied, all employers wherever located would be responsible for applying the PAYE procedures correctly to account for it in the same way as they would collect mainstream tax. The enabling legislation which governs local income tax would have to ensure that all employers, including those located in parts of the UK other than Scotland, would have an obligation to comply with collection mechanisms. This leads to the pragmatic conclusion that the enabling legislation would have to operate in the same way as the Scottish Variable Rate so that a local income tax was brought within the governance of HMRC and the PAYE system.

Parallels can be drawn with the UK tax system where foreign employers with operations or employees operating within the UK nevertheless are bound to apply PAYE under UK income tax rules even though the organisation itself is not within the UK tax net. Legislation for local income tax passed by the Scottish Government alone, even if within its powers to do so, could only be enforced within its territorial limits. There is an interesting extension to this in that it has long been the case that a foreign jurisdiction will not enforce the tax rules of another jurisdiction. However, the Courts' approach to enforcement within the boundaries of the UK is not something that has previously been tested and the question is whether the Courts will agree to enforce legislation passed by the Scottish Government in the other jurisdictions of the UK. In principal there is no reason why they should not but perhaps the better answer is that there is no valid reason why they should need to consider this point as employers should not face any additional burdens.

If a local income tax is introduced to be operated by HMRC it will be the responsibility of the employer to deduct and account for the tax to HMRC in exactly the same way as PAYE is applied. The responsibility for deciding how much should be paid to the Scottish Government will rest with HMRC.

By contrast, if the local income tax is introduced under an entirely separate Scottish collection and enforcement system not operated by HMRC, jurisdictional issues might arise and the operation of a separate system albeit in parallel would add to the administrative burdens of most business. The employer would have a duty to account for the local income tax directly to that collection agency and this raises the prospect of employers not based in Scotland having to act as tax collectors for the Scottish Government. This would inevitably

result in additional administration and cost and could be particularly unpopular with the non Scottish based employer.

The self employed

The self employed include people in business in their own account, partners in partnerships and members of Limited Liability partnerships. Unlike employed individuals and pensioners, the self employed do not pay income tax under PAYE. Instead their tax bill is assessed annually under the self assessment system. Tax is paid on 31 January following the end of the tax year and, in addition, the tax bill for the previous year forms the basis of two payments on account of the current tax year, which are made on 31 January and 31 July.

Example: a self employed individual has a tax bill of £20,000 for the tax year 2006/07 and £30,000 for the tax year 2007/08. His tax payments will be £10,000 on 31 January 2008, £10,000 on 31 July 2008 and £10,000 on 31 January 2009 in respect of the 2007/08 tax bill and in addition he will pay £15,000 on 31 January 2009 and £15,000 on 31 July 2009 on account of the tax bill for 2008/09.

The income which is assessed for each tax year is not necessarily earned in that tax year but is normally based on the accounts year which ends in the tax year. Example: A businessman with an annual accounting year of 30 April 2007 will pay tax on these profits in 2007/08.

This raises a number of issues in relation to the cash flow of both the local income tax as applied to the self employed.

Example: Assume the businessman in the above example carried on his business in England until 30 April 2007 when he migrated to Scotland at which time he earned a lower rate of profits. Despite the lack of connection of the profitability with Scotland he would pay the LIT.

Similar anomalies may arise where businesses headquartered in Scotland earn their profits in other countries and businesses in this category may perceive an unfairness about the application of the tax to income earned outwith Scotland and seek to migrate their base of operations.

Whereas employees will pay the local income tax on a monthly or weekly basis in line with their remuneration payment date, the self employed payment dates will require lump sum payments at six monthly intervals. The consultation paper notes the cash flow issues on introduction. How would this operate if an individual leaves Scotland?

For example if the businessman in the above example carried on business in Scotland until 30 April 2007 then became non resident in Scotland but still remained a UK taxpayer, would he be required to pay local income tax in July 2007, January 2008 and July 2008 and would it still be included in the payments on account in January 2009 and July 2009? Would his local income tax liability be apportioned in some fashion? As there would be no business cessation which triggered the national income tax rules which apply, it is arguable that in the interests of fairness some special rules would be required to address this position.

Section 3 What will be the impact of a Local income tax on our Economy and People?

Question 12 - In your opinion, will the introduction of a local income tax have positive economic impacts for Scotland?

Question 13 - To what extent would the tax rate influence your decision to live in Scotland?

Question 14 - To what extent do you agree with the following statements about the impact that a local income tax might have on your working patterns? (select on a scale of 1- 5 where 1 is strongly agree and 5 is strongly disagree)

- I am likely to work more hours** 1 2 3 4 5 **Don't Know**
- I am likely to work fewer hours** 1 2 3 4 5 **Don't Know**
- I am likely to work in a different location** 1 2 3 4 5 **Don't Know**
- I am likely to change jobs to a different Sector** 1 2 3 4 5 **Don't Know**
- It will have no impact on my work Patterns** 1 2 3 4 5 **Don't Know**
- Other work impacts**

Again we answer questions 12, 13 and 14 together.

Effects on behaviour – individuals

In this section we distinguish between people who already live in Scotland and immigrants (including English, Welsh and Irish immigrants) to Scotland.

(a) People who already live in Scotland

There is a possibility that some individuals may modify their behaviour as a result of the local income tax. It is possible that a few people in the borders area may choose to live south of the border and pay English Council tax and commute to work. It might be feasible for individuals to live in Carlisle and commute to Dumfries, for example, but existing geography (and cost of travel) is such that most individuals will not change their chosen lifestyle for the sums involved.

Such behaviour is only likely to occur if the cost per family unit of the local income tax exceeds the Council tax payment due for a property located in England.

While employment is likely to remain the driving force for most individuals in choosing where to live, the group most able to change where they live would be pensioners. Proximity to family and friends is more likely to be the driver here and in some cases local income tax will reduce the cost of living in Scotland for this group compared to paying Council tax particularly for low earner pensioners who do not claim council tax benefit.

(b) Immigrants to Scotland

Scotland's population is decreasing and an inward flow of migrant workers is considered beneficial to the country's economy. Therefore anything that discourages immigration by lessening the attractiveness of the country is likely to be detrimental.

Most individuals will consider tax rates before moving country and the rates that will be compared are a basic rate of 23% versus a rate for the rest of the UK of 20% in the case of the SVR and in the case of the local income tax a top rate of 43% versus a UK top rate of 40% in addition. An immigrant from outwith the UK is unlikely to factor council tax in the rest of the UK into this comparison and so will perceive Scotland to be the higher tax country. Given a choice it is likely such an immigrant will choose to move to the rest of the UK rather than Scotland if all other factors are equal. Alternatively he will seek a higher level of remuneration to compensate.

Potential Scottish immigrants who already live in the UK may have a better understanding of the incidence of council tax versus local income tax and hence may be less discriminating. However while the SVR is unlikely to generate changes in behaviour, the local income tax is

likely to have a greater impact in deterring the movement of higher earners who are likely to be the better skilled workers who would most benefit the Scottish economy.

Where immigrants to the UK are relocated by their employer it is likely they will seek enhancement of their reward package to compensate for any increased tax liability. The extent to which employers might accede to this is addressed in the next section.

In relation to both categories, as we have noted above, local income tax will not apply to dividend income, so its introduction may prove a driver for those who own family and private companies to extract profits by way of dividend rather than by way of salary. There are other behavioural aspects to the change from a property based tax to an income based tax. For example, despite the gap between property valuations for Council tax generally, the bandings are related to property value. In some instances this may be a deterrent to making property improvements which fall into the “nice to have” category as distinct from the “required” category if these are seen as moving properties into a higher tax valuation band. An income based local income tax would disperse these deterrents. There may be similar factors arising between choice of individual properties and location of property which would also cease to apply.

In general, the higher the rate of income tax the greater the disincentive to work, as the worker has less benefit to show for his efforts.

Effects on behaviour – business

Business behaviour is likely to differ according to whether the business can be regarded as a Scottish domestic business or an inward investment business.

The issues which arise for employers are:

- Does the cost of employing Scots increase through higher earnings to compensate for increased income tax?;
- Does doing business from a Scottish base become more expensive?;
- Are there increased administrative costs involved in employing a Scots work force?.

Domestic employers are unlikely to increase earnings of Scottish employees. It should be readily apparent to domestic employers that the increased income tax liability is offset by the Council tax saving and any differential should carry no more weight than differential council tax rates between different local authorities does. It is very unlikely that employers who carry out a proper analysis of the issues will be influenced by the increased tax rate.

However, employers who relocate employees to Scotland may face a communication exercise to ensure that their employees properly understand the tax effect.

Non UK employers may be swayed by the increased local income tax. When choosing the country in which to base their operations, most entities carry out high level review of certain specific key features, one of which is the headline rate of income tax. In that review Scotland would come out with a headline rate of 23% against an England, Wales and Northern Ireland rate of 20%. Few international employers will explore this further or take into account property taxes by way of offset. Similarly, in an international comparison of income tax rates, Scotland will come out with a higher rate than many other countries.

When international employers relocate employees to other jurisdictions it is common to enter into tax equalisation arrangements with these employees, designed to ensure the employee is not worse off than if he remained in his home jurisdiction. While the differential rates of income tax almost always feature in such arrangements, local property taxes are not always taken into account. It may be expected that the abolition of council tax would feature positively in any cost of living allowance paid to immigrant workers, but it is far from certain that this will be the case in all cases. Therefore, it is possible a perception will develop in international

circles that Scotland is a more expensive place to do business than the rest of the UK, resulting in international business diverting its operations away from Scotland.

Many employers who have operations throughout the UK will operate their payroll from just one location, meaning that Scots workers may be paid from an English location (or vice versa). As noted above, it should not be the responsibility of the employer to determine who is a Scots resident liable to the additional income tax charge: that should be a function of the PAYE system. Nor should employers face any penalties in this respect additional to those the correct operation of PAYE imposes anyway. Thus there is no significant additional administrative burden imposed on employers.

Q15 How important is it that your local authority has the power to set a tax.?

No response

Question 16 - Please provide any comments you may have about local income tax and accountability and democracy.

No response

Question 17 - If you have any specific comment about the impact of our proposals on equality issues, please tell us what these are.

No response

Sections 4, 5 and 6

Question 18 - Do you feel that the money raised from a Local Income Tax should be distributed to councils according to:

- Need?
- Population in each area?
- The amount of local income tax raised in each area?
- Don't know
- Other (please specify)

Question 19 - To what extent do you agree that Scotland should receive equivalent monies to Council Tax Benefit, after the abolition of council tax? (where 1 is strongly agree and 5 is strongly disagree)

Question 20 - To what extent do you agree that local authorities should play a part in setting a second homes tax? (Where 1 is strongly agree and 5 is strongly disagree)

Question 21 - To what extent do you feel second homes tax should be collected by:

- Her Majesty's Revenue and Customs (HMRC)?
1 2 3 4 5 Don't Know
- A Scottish local collection agency?
1 2 3 4 5 Don't Know
- A private collection agency?
1 2 3 4 5 Don't Know
- Local authorities?

1 2

3 4 5 Don't Know

We have chosen not to respond to these questions as they are of a more political nature.

Section 7 – Are there other taxation systems that should be considered?

Question 22 - Which do you feel is the fairest approach to taxation? (select 1 only)

- Council Tax**
- Land Value Tax**
- Local Income Tax**
- Environmental Tax**
- None of the above**
- Don't know**

Question 23 - Which approach do you feel will provide a more wealthy Scotland? (select 1 only)

- Council Tax**
- Land Value Tax**
- Local Income Tax**
- Environmental Tax**
- None of the above**
- Don't know**

Question 24 - If a Local Income Tax is introduced, what would be the most significant factor (good or bad) for you? (select 1 only)

That the Council Tax will be abolished

I / my household shall be better off

I / my household shall be worse off

That a Local Income Tax system would be fairer than the council tax

That it will help to make Scotland a wealthier and fairer place to live and work

Don't know

Other (Let us know what the significant factor is)

Various studies have been conducted from time to time into alternatives such as Land Value Tax Environmental taxes and local income taxes. All have drawbacks as well as advantages and we suggest that a fuller review of these studies be undertaken in order to assess which of the approaches suggested is the fairest. However we observe that Council tax has the advantage that it is an established and accepted system. As it is property based it is hard to evade and it is relatively easy to collect the tax. It does not require new collection systems to be developed nor does it place Scotland at a competitive disadvantage internationally. It allows local accountability. Council rebates ensure those that have low incomes do not have to pay. It creates a link between cost of services and the user of the services. In the absence of such a link it is arguable that those members of the population who pay least local income tax but use most services will demand ever greater expansion of the provision to the detriment of the pool of taxpayers who will fund them. We therefore suggest that the merits of retaining the Council tax system in direct comparison to the merits of introducing a local income tax system are not adequately addressed in the consultation paper and that the case for the introduction of a local income tax has not been made.

Should you have any queries on this submission please contact the undersigned. We would welcome the opportunity to discuss our comments further with you.

Yours faithfully

for PricewaterhouseCoopers LLP

Rhona Irving
Tax Partner

Appendix 1

Analysis of Scottish Taxpayers

Source (HMRC Survey of personal incomes. Income and Tax by Parliamentary constituency 2005 06)

	No	Mean income £	Average per head £
Self employed individuals	263,000	19,900,000,000	75,665
Employed individuals	2,100,000	20,600,000,000	9,810
Pension income	545,000	11,300,000,000	20,734

	Per week £	Annualised £
Median gross weekly earnings	441.50	22,958

Appendix 3

Estimated tax raised by a Scottish Local Income Tax with no upper income cap

	Lower limit of income band	Higher limit of income band	No of individuals (000s)	Amount (£000)	Personal allowance	Minimum taxable income	Tax at 3% per head (£)	Estimate total tax raised (£000)
Self employment income								
	4895	6000	13	54	5435	0	-	
	6000	10000	48	286	5435	565	17	814
	10000	15000	50	420	5435	4,565	137	6,848
	15000	20000	38	432	5435	9,565	287	10,904
	20000	30000	48	751	5435	14,565	437	20,974
	30000	50000	34	802	5435	24,565	737	25,056
	50000	70000	12	480	5435	44,565	1,337	16,043
	70000	100000	7	443	5435	64,565	1,937	13,559
	100000	200000	9	850	5435	94,565	2,837	25,533
	200000		3	710	5435	194,565	5,837	17,511
Employment income								
	4895	6000	78	397	5435	0	-	
	6000	10000	320	2280	5435	565	17	5,424
	10000	15000	423	4900	5435	4,565	137	57,930
	15000	20000	387	6330	5435	9,565	287	111,050
	20000	30000	458	10500	5435	14,565	437	200,123
Appendix 3 Continued								
	50000	70000	65	3280	5435	44,565	1,337	86,902
	70000	100000	27	1820	5435	64,565	1,937	52,298
	100000	200000	18	1740	5435	94,565	2,837	51,065
	200000		5	1230	5435	194,565	5,837	29,185
Pension income								
	4895	6000	13	54	5435	0	-	
	6000	10000	155	1040	5435			

						565	17	2,627
10000	15000	167	1650	5435	4,565	137	22,871	
15000	20000	84	1060	5435	9,565	287	24,104	
20000	30000	69	1120	5435	14,565	437	30,150	
30000	50000	38	709	5435	24,565	737	28,004	
50000	70000	11	256	5435	44,565	1,337	14,706	
70000	100000	5	136	5435	64,565	1,937	9,685	
100000	200000	3	94	5435	94,565	2,837	8,511	
200000		1	61	5435	194,565	5,837	5,837	
Total		<u>2,906</u>					<u>1,111,324</u>	

Source (HMRC Survey of personal incomes. Income and Tax by gender region and country 2005 06)