Pensions and Scottish rates of income tax

In 2018-19 the Scottish Government introduced new tiers and rates of income tax for Scottish residents. It proposes for 2019-20 keeping the same tiers and rates but increasing the tax thresholds in line with inflation, except for the higher and top tax rate thresholds which will be frozen. This means the Scottish rates of income tax are increasingly diverging from those rates applied in the rest of the UK (rUK).

If you only read one thing…

- Different rates and thresholds on income tax for Scottish residents has implications for tax relief on pension contributions and the rates at which pension income is taxed.
- Every January HMRC informs pension schemes of the residency tax status of their pension scheme member (based on information submitted to HMRC in July the previous year).
- Once identified, the residency tax status is locked in for the remainder of the tax year, even if the member moves part way through the year to somewhere else in the UK.
- HMRC pays tax relief direct to the scheme at 20% for all pension paid by Scottish residents. Intermediate, higher and top rate taxpayers have to reclaim any additional tax relief. Starter rate taxpayers (paying 19% tax) will receive slightly too much tax relief.
- The increasing divergence of Scottish income tax rates from those applied in the rUK will have implications for those making spending decisions. Some may wish to consider withdrawals that are tax-free or income from investments (which is taxed at rUK rates), ahead of pensions income which will be taxed at the Scottish rates of income tax.

Having different rates and thresholds for income tax in different parts of the UK has two important implications for pension schemes and their members. First, pension contributions are entitled to income tax relief, so differently located residents will be entitled to different levels of relief. Second, pension schemes pay their members pension income taxed on a PAYE basis. So, it's important pension schemes can identify Scottish residents.

This factsheet outlines what this difference in income tax structure means for Scottish residents saving into a pension. It also explores what the increasing divergence in income tax rates from those applied in the rUK means for those making income spending decisions.

Taxing pension income

All Scottish residents are identified by an 'S' prefix to their tax code. Pension schemes operating a payroll will tax income on an emergency tax basis initially, until HMRC notifies them of the pension scheme member's tax code. They can then tax Scottish residents on the correct tax basis.

Pension schemes operating relief at source

HMRC has a set approach to how it treats Scottish residents who are members of pensions schemes operating relief at source.

By using the annual return of individual information submitted by scheme administrators by 5 July each year, HMRC identifies pension scheme members resident in Scotland. Each January HMRC sends the individual scheme members' residency tax status to pension scheme administrators who are operating relief at source pension schemes. Scottish residents have an 'S' identifier. Welsh residents have a 'C' identifier. Those unmatched have a 'U'. Everyone else has a blank field.

HMRC has developed a look-up service for scheme administrators to use for members who join after July each year. If the scheme administrator uses the service:

- between April and December then they will get the member's current tax year residency; or
- between January and April, they also get the residency status for the next tax year. Scheme administrators will be able to use this for the next tax year to give the correct rate of relief at source to members who have joined the scheme since HMRC sent the notification of residency status report in January.

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At this point, the current year residency status may be different from the one the scheme administrator has been applying for the current tax year. If so, the HMRC reconciles this at the end of the tax year, so the member gets the relief at source at the correct rate.

If the scheme administrator is unable to look up the status before they apply tax relief at source to the first contribution, they must default the residency status to the rest of the UK and maintain this rate for the whole tax year. HMRC sorts out any shortfall or excess of tax relief at the end of the tax year.

Changing residency part way through a year

Importantly, once their tax residency status is identified before the start of the tax year, that status is locked in, and even if the person moves part way through the year to somewhere else in the UK, they retain that residency tax status for the whole of the tax year.

Scottish income tax rates

There is a five-tier income tax system for Scottish residents. For 2019-20 tax year, the Scottish government has increased the tax threshold in line with inflation, except for higher and top rate tax thresholds which will be frozen.

Name of band	Band	Rate
Starter	£12,500 - £14,549	19%
Basic	£14,549 - £24,944	20%
Intermediate	£24,944 - £43,430	21%
Higher	£43,430 - £150,000*	41%
Top	Over £150,000*	46%

*The personal allowance is reduced by £1 for every £2 earned over £100,000

All pension contributions paid by Scottish residents to pension schemes operating relief at source automatically receive 20% tax relief paid direct to the scheme. Even though those in the starter band are only paying 19% tax, HMRC will not attempt to reclaim any overpayment of tax relief.

Intermediate, higher and top rate taxpayers, however, have to reclaim any difference in tax relief. They can do this by completing a self-assessment tax return, or intermediate and higher rate taxpayers can contact HMRC direct to ask for an adjustment in their tax code. But will someone earning just over £25,000 be bothered to claim the additional small amount of tax relief?

For a member earning £27,000 a year and paying 5% pension contributions of £1,350 a year the scheme would receive £337.50 direct from HMRC giving a total pension contribution of £1687.50. The member could claim an additional 1% tax relief of £16.88. But the effort to get such a small amount could put them off.

HMRC has announced it will continue to work with the industry to develop different – possibly automatic – solutions for future tax years.

Influencing investment and savings decisions

The Scottish rates of income tax only apply to 'non-savings non-dividend income', which includes earnings, pensions, rental profits and income distributions from discretionary trusts. Income from investments is taxed at rUK rates. So, a Scottish resident with earnings between £43,430 and £50,000 will pay income tax at 41%. But a Scottish resident with investment income in that same range will pay income tax at 20%. This may influence their savings and investment decisions.

The order in which additional funds are accessed from investments and tax-efficient wrappers to supplement earned income is particularly pertinent for Scottish taxpayers in the £43,430 to £50,000 income range. They may wish to consider tax-free withdrawals from Isas, withdrawals from investment bonds, maximising natural income and realising gains on investments outside their tax-efficient wrappers – which will generally be taxed at no more than 20% – in preference to drawing on their pension income, which will be taxed at the higher rate of 41%.

Those who are still earning and paying into a pension, may want to use pension salary sacrifice to reduce their earnings, and so their marginal tax rate, in exchange for a higher employer pension contribution. Employers may be more willing to offer this, as they save on employer national insurance contributions (NICs), and some may pass part of this saving on to their employees.

Welsh government

From April 2019, the National Assembly for Wales will be able to vary the rates of income tax payable by Welsh taxpayers, although it has said no changes will be introduced before 2021. It may be that a similar approach for that adopted for Scottish residents contributing to a pension scheme may have to be rolled out to Welsh pension scheme members as well, if any future changes are made.

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Difference between Scotland and the rUK

The increasing divergence between Scottish rates of income tax and those applying in the rUK means those earning above £26,993 will pay more tax if they are resident in Scotland compared to living in the rest of the UK. The biggest impact will be felt by those earning between £43,430 and £50,000. They will also pay a higher combination of tax and national insurance contributions (NICs).

For 2019-20, NICs are paid at 12% on earnings between roughly £8,600 and £50,000, and 2% on earnings over £50,000, regardless of where in the UK the person lives. These NIC thresholds are aligned to the rUK income tax rates. As NIC thresholds and Scottish income tax thresholds further diverge, Scottish residents will pay 53% combined marginal rate of income tax and NIC on a larger slice of their earnings. On earnings between £43,430 and £50,000, they will pay 41% tax and 12% NICs (totalling 53%) compared with 20% income tax and 12% NIC (totalling 32%) if they were resident somewhere else in the UK.