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THE IMPACT OF SCOTTISH INDEPENDENCE ON TAX, PENSIONS AND FINANCIAL SERVICES

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THE IMPACT OF SCOTTISH INDEPENDENCE ON TAX, PENSIONS AND FINANCIAL SERVICES

If Scotland were to vote for independence from the rest of the UK, Scotland would need to enter new cross-border tax agreements, which could affect current tax and pensions arrangements. Scotland also wants to join the EU, which could have a profound impact on cross-border trade between Scotland and the rest of the United Kingdom (rUK), including a requirement for duties and a border infrastructure, as well as significant implications for financial services.

In our previous three briefings, we have looked at how Scotland could hold a valid independence referendum (probably only with Westminster legislation), when it might be (before the end of 2023), when independence might occur (before the next Scottish elections, in May 2026), and how independence would affect laws in Scotland and rUK and individuals and companies on either side of the border. We also looked at the currency question, noting the contrast between the cautious approach taken by a commission established by the SNP and the SNP conference's rejection of that caution in favour of a new Scottish currency at, or shortly after, independence.

We turn now to issues of tax and pensions that would face those doing business in rUK and Scotland before considering the implications for business and individuals that would occur if Scotland were to join the EU. Finally, we look at the implications of Scottish independence for the financial services industry.

Tax

Independence raises difficult questions of tax policy, as well as numerous practical issues for individuals and companies with interests and business cross-border.

The Scottish Government proposed at the time of the first referendum to cut corporation tax to 3% below rUK's rate and to introduce a series of tax incentives. This raises the spectre of tax competition between the two countries. The long-term consequences are unpredictable, but in the short term some may wish to take advantage of lower rates and migrate entities to Scotland prior to independence. Others will be concerned about uncertainty (whether tax, legal or economic) and therefore migrate in the other direction. In both cases there would likely be questions as to whether the migration is tax-effective; however, in principle, migration before independence would be considerably more straightforward than migration has historically been (e.g. to Ireland), with no exit taxes and few other frictional costs. This prospect may alarm HM Treasury, colour other aspects of negotiations, and perhaps prompt new anti-avoidance rules.

A tax treaty between rUK and Scotland would need to be in effect by independence to prevent double taxation of Scottish and rUK businesses and to prevent payments to/from Scotland becoming subject to withholding tax. However, the terms of that treaty might be contentious (particularly given Scotland's intention to capture business from rUK).

rUK would, as the continuator state, retain the benefit of the UK's historic network of around 120 tax treaties. Scotland would not – and on the face of it that would present considerable difficulties to Scottish companies investing and operating in other countries and to companies from other countries investing/operating in Scotland. Negotiating a new treaty network would take time, likely many years. There is, however, precedent for Scotland simply to agree bilaterally with other countries that they each consider themselves subject to the relevant UK treaty – certainly not an instant process, but considerably faster than a full treaty negotiation.

In terms of domestic legislation, it seems likely that Scotland would choose to inherit UK tax legislation as at independence, save for the specific areas which have been the subject of political focus (such as tax rates, incentives and anti-avoidance rules). Any more fundamental change would seem impractical (as well as highly risky). Over time, the two systems could be expected to diverge, as happened with, for example, Ireland and Hong Kong.

On a practical level, the most likely overall outcome is that rUK would treat Scottish individuals and companies in the same way as it treats any other country's individuals and companies (and vice versa). Given the history of being the same country, that would have a host of complex consequences, including:

- rUK companies' Scottish operations would be treated as permanent establishments, separately taxable in Scotland, and vice versa.
- Arrangements and transactions between rUK and Scottish entities/ permanent establishments would then be subject to transfer pricing, creating a significant compliance burden (and the potential for arguments between the rUK and Scottish authorities as to who has the taxing right). It has been suggested that this could be avoided by creating a formulary apportionment system between Scotland and rUK. However, as that would give Scotland more favourable treatment than any other country, it is unclear whether it would be consistent with the UK's WTO obligations. Similarly, that kind of special treatment for residents of one other country (and nowhere else) would seem to be incompatible with a future Scottish membership of the EU. These two issues would likely prevent straightforward solutions to this or the other complexities we identify.
- Groups containing rUK and Scottish entities would be broken for tax purposes. This could have a number of complex effects. Going forward, cross-border groups would in practice lose the ability to move assets tax-free and to surrender losses within the group.
- Scottish companies would only be required to operate PAYE for employees in rUK if they have a taxable "presence" in rUK. If they didn't, they would not have to operate PAYE, and rUK employees would have to pay any income tax due to HMRC through self-assessment. Similarly, companies based outside Scotland may no longer have to operate PAYE for employees in Scotland.
- A large number of rUK residents could claim domicile in Scotland, and, as "non-doms", be taxable on foreign income/gains only when remitted to rUK. Presumably, rUK rules around domicile would need to be changed to avoid a material loss to the Exchequer (and Scotland would face similar concerns). Again, creating special rules targeting one country could raise complex questions of compatibility with WTO trade rules and (potentially for Scotland) EU law.
- Similarly, the ease by which many individuals could shift their residence from rUK to Scotland, or vice versa, would likely concern both tax authorities.
- Various tax rules impose exit charges on companies that cease to be resident in the UK. So, for example, an rUK company holding real estate or another capital asset would, on ceasing to be an rUK resident, be subject to rUK CGT on its unrealised capital gain – and similar rules would apply to intangible property, loan relationships and derivatives. Any unrealised losses would also crystallise for tax purposes, but in many cases an emigrating company would have no use for the losses. Under current UK tax legislation, these exit charges may be triggered upon independence – and unless new reliefs and/or exemptions were created, this could amount to a considerable windfall for the UK Treasury and a considerable tax burden on affected companies. It therefore seems likely that some form of deferral arrangement would have to be put in place (and that should be possible within the WTO and EU frameworks).

Pensions

Pension schemes would not be immune from the effects of Scottish independence, although one of the key concerns raised by potential

independence following the 2014 vote has receded due to Brexit.

That concern was that a scheme with a mix of Scottish and rUK employees could be classed as a "cross-border scheme" following independence and would have to meet various conditions, including seeking authorisation from the Pensions Regulator and, crucially, complying with much more onerous funding requirements than usually apply. In the absence of exemptions or transitional provisions being agreed, this would likely have resulted in schemes taking steps to segregate Scottish pension liabilities from rUK pension liabilities in order to avoid having to meet these onerous obligations. However, following Brexit, the legislation governing cross-border schemes ceased to apply, with no detailed regime replacing it; the immediate authorisation and funding requirements are no longer a concern (although such concern could be revived if Scotland joins the EU and is required to apply the same rules to existing schemes).

In terms of other pensions-related implications:

- Over recent years, a number of employers have given their pension schemes assets instead of cash as part of their funding. In many cases, these contributions have been structured using a Scottish Limited Partnership (SLP) in order to overcome some technical concerns under employer-related investment legislation. SLPs have been effective due to a quirk in the legislation. This quirk depends on the vehicles being located in the United Kingdom. This may not survive independence, leading to a potential need to restructure. In the majority of cases, it may be possible to get comfortable that structures can be continued, but detailed consideration will be needed.
- Regarding regulation, the UK pensions market is governed by a number of key institutions, such as the Pensions Regulator and the Pension Protection Fund (PPF). Decisions will need to be taken as to whether these bodies' functions will be split between new regulators and, if so, on what basis.
- The PPF's position in particular is likely to be a point for negotiation. The PPF acts as a statutory "lifeboat", providing a proportion of benefits of schemes whose employers have become insolvent, and it is already responsible for a number of schemes previously operated north of the border. For example, a Scottish PPF, split on the basis of population, would be significantly smaller than the existing UK-wide body – there are bound to be questions as to how sustainable it would be and whether levies would rise. Many employers have put in place arrangements designed to reduce the levy they pay to the PPF – would these continue to be recognised?
- Pension schemes are also particularly exposed to currency issues if independence results in mismatches between the currency of the scheme's assets and liabilities. Pensioners may also be adversely affected where the currency in which pensions are paid depreciates against the currency of their country of residence. There have been proposals in Scotland for the Scottish Government to protect Scottish pensioners under UK schemes against this risk.

Other implications will come to light, particularly if different income tax levels are introduced, as was suggested at the time of the first referendum (given that contributions to registered pension schemes are normally tax deductible). It remains to be seen how all these issues will be resolved.

The European Union

The EU will still be a day one issue on Scottish independence but for different reasons than it would have been following the first referendum, when independence would have left rUK within the EU and Scotland outside it. But the SNP's stated desire for Scotland rapidly to become a member of the EU will still cast a shadow over the independence process.

The day one issue will be whether an independent Scotland will be allowed by the EU to assume some or all of the UK's rights and obligations under the Trade and Cooperation Agreement between the UK and the EU. If not, then Scotland will be faced with its own "hard Brexit", trading with the EU on WTO terms rather than those in the TCA. The EU may also

wish to bind Scotland to at least some of the obligations of the UK under the EU-UK Withdrawal Agreement, such as the UK's obligations with respect to EU citizens' rights and the separation provisions dealing with protections for EU intellectual property and other rights. But it may not be possible to continue the same treatment for goods traded between Northern Ireland and Scotland as apply today under the Northern Ireland Protocol as this may be inconsistent with Scotland's new status. These issues, like Scotland's membership of the EU, could become a political pawn.

In the longer term, securing Scotland's membership of the EU will not necessarily be a quick process. Until it is formally independent, it is hard to see how Scotland could apply for, negotiate, sign or ratify an accession treaty. Similarly, all the EU's members would have had to recognise Scotland's independence before a treaty could be signed. Whether Scotland becomes a member by amendment to the EU's existing treaties under article 48 of the Treaty on European Union (the Scottish Government's preferred route during the first referendum) or by the more probable route of a separate treaty of accession under article 49, Scotland must negotiate and reach agreement with all the current members of the EU, which agreement must then be brought into legal force. These two stages could each easily take at least 18 months.

Some, perhaps most, EU member states may be prepared to rush the first stage and the second stage – the ratification by each EU member state of the accession treaty with Scotland through each member state's national legal and political procedures – but it would only take one member state to refuse to do so or to encounter problems in the process in order to delay Scotland's accession. The quickest time in which the process of joining the EU has been completed is two years and nine months, for Finland.

Whatever the merits of Scotland's membership of the EU, its application risks becoming a pawn in unrelated national and international politics. The example of Spain, with its Catalonian separatist movement, was much cited at the time of the first referendum (subsequently, in 2017, there was an independence referendum that was unlawful under Spanish law and that led to the gaoling of some pro-independence politicians), but other member states may also have an interest in discouraging any popular disposition towards division. For example, Cyprus, Greece, Romania and Slovakia, along with Spain, have not recognised the independence of Kosovo, each for its own historical and cultural reasons. States with separatist movements might not oppose Scottish accession outright if done legally and with the agreement of the UK, but they will appreciate that the position of Scotland could set a precedent for subsequent secessions. They will have every incentive to make the accession process visibly arduous and costly. Scotland is setting a course across unknown, and quite possibly treacherous, terrain.

Duties and VAT

As an independent country, Scotland would be free to reach such agreement as it saw fit with rUK (within the bounds of international rules) on import duties and VAT, and to legislate as it wished. The goal of potential membership of the EU could, however, restrict Scotland's freedom of action in this area.

The EU would be unlikely to allow Scotland to inherit the opt-outs and special provisions enjoyed by the UK when it was a member of the EU, such as the opt-outs from the requirement to join the euro and from the Schengen borderless travel area. In particular, the border between rUK and a Scotland within the EU is likely to be a major aspect of negotiations. That border is currently completely open, to both people and goods, and would likely remain at least largely so under any independence agreement between Scotland and rUK.

If and when Scotland joined the EU, the position would be different. Northern Ireland offers an obvious parallel. Under the TCA between the EU and the UK, Northern Ireland is effectively within the EU's single market in order to keep its land border with the Republic open and thus to support the Belfast Agreement. The result of this is that goods entering Northern Ireland from Great Britain are subject to various EU border controls.

Membership of the EU could become a political pawn.

Similarly, some sort of border infrastructure between a Scotland in the EU and rUK would be needed in order to allow for the checks, certificates, duties and passport stamps currently required for goods and people to go from Dover to Calais (and vice versa) in order to uphold the principles of the EU's single market. This border "wall" – 154km long with 21 roads and two railway lines crossing it – could have serious implications for Scotland's trade with rUK. 60% of Scottish exports go to rUK; less than 20% of Scotland's exports go to the EU. Exports from rUK to Scotland represent a significantly lower proportion of rUK exports. By comparison, prior to Brexit, the UK's trade with the EU represented about 50% of its exports.

If it wished to join the EU, Scotland would have to adopt a VAT system consistent with EU VAT law. Whilst this may sound uncontroversial given that Scotland was, until recently, part of the EU, the UK had many exemptions from the standard EU rules which are no longer available to countries now joining the EU. Unanimous amendment of the VAT Directive would be required to permit Scotland the use of similar derogations, and this seems unlikely.

For example, Scotland would likely be required to implement VAT on children's clothing at the main VAT rate and to charge a minimum VAT of 5% on books; in the UK, these items continue to have a 0% VAT rate. In addition, Scotland would lose the right to apply the 0% rate in relation to 54 different areas, including food, water and health care. Joining the EU may, therefore, lead to an increase in prices for Scottish consumers, with the result that some consumers may head south to do their shopping. This would be exacerbated by any changes which Scotland or rUK chooses to make to its VAT system, or simply by a natural divergence in the two systems over time.

Businesses with a presence in both Scottish and rUK entities will have to register for VAT and file VAT returns in both jurisdictions (rUK and Scotland).

Businesses will lose the ability to form a VAT group between their Scottish and rUK entities. This lack of VAT grouping will give rise to particular difficulties in those industries which rely heavily on VAT groups to mitigate the impact of irrecoverable VAT and/or to streamline business operations or minimise cash flow costs. Many financial groups, in particular, may need to reorganise their group structures and intra-group arrangements significantly, even if they only involve the use of service centres in Scotland.

Financial services

Scotland will need to establish its own financial regulator and resolution authority and make arrangements for continuing the licences and supervision of Scottish firms that are currently authorised and supervised by the UK authorities. The rUK regulators will continue to authorise and supervise rUK-incorporated firms.

Scotland and rUK would need to decide how they wished to deal with the regulation and supervision of firms from one jurisdiction that operate through branches in the other and the cross-border trade in financial services between the two jurisdictions.

One possibility might be a broad mutual recognition arrangement which aims to replicate many of the features of the passport regime within the EU – although this might not benefit non-UK firms currently operating through branches in the UK which deal with clients throughout the UK. However, Scotland's flexibility to operate a mutual recognition arrangement of this kind with rUK may be constrained if Scotland joins the EU; Scotland and rUK may end up treating each other's financial services firms in much the same way that the UK currently treats non-UK firms. Whilst the immediate impact might be mitigated by transitional provisions and equivalence decisions under inherited legislation, this could create significant barriers to cross-border trade in financial services between Scotland and rUK, at least as regards retail customers. The impact would be exacerbated to the extent that the regulatory regimes in Scotland and rUK diverged after independence.

If Scotland joins the EU, any previous equivalence decisions in favour of the UK may not need to be replaced by European Commission decisions under EU legislation. In any event, the rUK and Scottish regulators would need to put in

place memoranda of understanding and other cooperation arrangements governing the supervision of cross-border activity. Financial services firms would need to prepare contingency plans for the possibility of new barriers to business between Scotland and rUK.

Similar issues would arise for the rUK-based trading venues, central counterparties, central securities depositories and payment systems that currently serve firms based in Scotland. These would continue to be regulated and supervised by rUK authorities, and the terms of access by Scottish firms would likely be similar to those of other non-UK firms. Absent any broader mutual recognition regime, Scotland may apply the inherited UK legislation to recognise the equivalence of UK regulation for the purposes of central counterparty clearing, central securities depositories and the securities and derivatives trading obligations, but if it rejoins the EU, those decisions would then be for the European Commission.

The new Scottish regulators would also need to put in place new memoranda of understanding or cooperation arrangements with EU and other non-UK regulators as they would no longer be parties to those negotiated by the UK regulators. Scottish firms would also need to confirm that their new home state and regulator do not adversely affect their ability to continue to operate through branches or cross-border in non-UK jurisdictions.

Conclusion

The practical issues that arise on separating Scotland from rUK cannot be underestimated, despite the existence of a Scottish Government since devolution in 1999. Everything run on a UK-wide basis must be split. Laws that are in force in Scotland and in rUK on independence day will continue in force, but both countries need to look at their statute books in order to ensure that they meet the requirements of each country's new or revised form. For example, the Scottish judges sitting in the (rUK) Supreme Court will, presumably, be removed; the almost innumerable UK statutory references to Scotland may need removal or amendment; and the Royal Charter establishing the BBC provides for there to be a trust member for Scotland, who will, presumably, lose his post on independence day. The list is endless.

The practical issues go beyond the two Governments. Anyone with operations in, or dealings with, Scotland needs to consider how the changes required for, or wrought by, independence affect their position.

Much of the work to achieve separation will require negotiation between Scotland and rUK, which will be difficult, quite possibly fractious, given the divergence of interests between the two. Extensive quantities of black coffee may be needed to see people through late nights of negotiation, but, if anything is to be achieved, any stimulant must be supplemented by a huge amount of goodwill on all sides.

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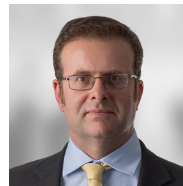

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