National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

The administration of the Scottish Rate of Income Tax 2015-16

HC 871 SESSION 2016-17 19 DECEMBER 2016
SG/2016/239

Our vision is to help the nation spend wisely.

Our public audit perspective helps Parliament hold government to account and improve public services.

National Audit Office

HM Revenue & Customs

The administration of the Scottish Rate of Income Tax 2015-16

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 19 December 2016

Presented to the House of Commons pursuant to
Section 9 of the National Audit Act 1983

Presented to the Scottish Parliament pursuant to
Section 80HA of the Scotland Act 1998 as amended
by the Finance Act 2014

Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

16 December 2016

HC 871 | £10.00
SG/2016/239

11400 12/16 NAO

Contents

The National Audit Office study team consisted of:
Chris Coyne, Morgan Robb and Andrea Scott, under the direction of Steven Corbishley.

This report can be found on the National Audit Office website at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Enquiries: www.nao.org.uk/contact-us

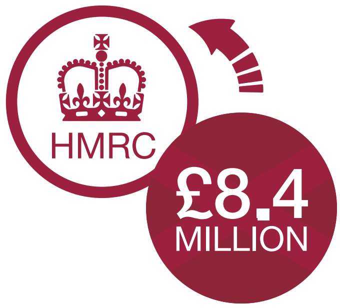
Website: www.nao.org.uk

Twitter: @NAOorguk

Key facts

individuals HMRC identified as potential Scottish taxpayers and who were issued with a Scottish taxpayer notification letter

the number of potential Scottish taxpayers who were excluded from the initial identification exercise, but received a Scottish tax code early in 2016-17



amount reimbursed to HMRC by the Scottish Government in respect of implementing the Scottish Rate of Income Tax during 2015-16

Summary

Introduction

1 The Scotland Act 2012 introduced powers for the Scottish Parliament to apply a Scottish Rate of Income Tax (SRIT) to the non-savings, non-dividend income of Scottish taxpayers from 6 April 2016.

2 For the 2016-17 tax year, the UK basic, higher and additional income tax rates paid by Scottish taxpayers are reduced by 10% (10 pence in the pound). The Scottish Parliament used its powers to apply a single additional Scottish rate across all tax bands. In December 2015, the Scottish Government proposed setting the Scottish rate at 10% for 2016-17, effectively matching the rates in the rest of the UK at 20%, 40% and 45%. This rate was formally approved by the Scottish Parliament in February 2016 (**Figure 1**).

3 The Scottish Parliament's tax-raising powers were further enhanced by the Scotland Act 2016. From 2017-18, the Scottish Parliament will have the power to set the rates and band thresholds (excluding the personal allowance) that apply to all non-savings and non-dividend income tax paid by Scottish taxpayers.

Figure 1

The Scottish Rate of Income Tax

Note

1 Band thresholds for 2016-17 tax year.

Source: The Scottish Government

4 For 2016-17, there is no difference between rates in Scotland and rates in the rest of the UK. In its draft budget for 2017-18 announced on 15 December 2016, the Scottish Government proposed freezing income tax rates in Scotland, with no increases in the basic, higher or additional rate. However, the higher rate threshold will be frozen in real terms, which means from 2017-18 there could be a divergence in the higher rate threshold between Scotland and the rest of the UK. If the draft budget is approved, Scottish taxpayers will pay the 40p higher rate if they earn £43,430 or more, whereas taxpayers in the rest of the UK will pay the 40p higher rate if they earn £45,000 or more.

5 HM Revenue & Customs (HMRC) continues to administer and collect Scottish income tax as part of the UK tax system. It will pay revenues related to its Scottish tax powers into the UK Consolidated Fund in the same way as it does for all other tax receipts. These revenues will subsequently be transferred to the Scottish Government and the Scottish Government's resource block grant will be reduced accordingly reflecting its revenue-raising powers.

6 In 2016-17, the first year the SRIT is being collected, the deduction to the block grant equals the non-savings, non-dividend income tax receipts generated by the Scottish rate of 10%. This represents the amount of revenues foregone by the UK Government at the point when tax raising powers were devolved to Scotland. As the Scottish Government has set SRIT at 10%, the amount of tax generated will exactly offset the reduction in the block grant. The deduction was forecast by the Office for Budget Responsibility as £4.9 billion.[1]

7 From 2017-18, the Scottish Government is taking on further income tax powers. The reduction in the resource block grant from 2017-18 will equal total non-savings non-dividend income tax generated in Scotland in 2016-17, uplifted using the mechanism set out in the Scottish Government's fiscal framework. Each year, both the tax receipts generated and the block grant deduction will initially be based on a forecast and then reconciled to actual receipts collected which will become known around 15 months after the end of the financial year in question.

8 Therefore, the amount of SRIT collected in 2016-17, and as disclosed in HMRC's annual accounts for 2016-17, will be based on estimated data. These accounting estimates will be subsequently updated in the 2017-18 account in line with generally accepted practice. The time lag in confirming the actual amount of SRIT collected in 2016-17 is due to the pay-as-you-earn (PAYE) and self-assessment process within the UK. To administer PAYE for taxpayers, HMRC undertakes an end-of-year-reconciliation to assess whether individuals have paid too much or too little tax in any given tax year. Similarly, self-assessment tax returns are, in some cases, not provided to HMRC until ten months after the end of the tax year to which they relate.

1 Office for Budget Responsibility, *Economic and fiscal outlook: devolved taxes forecast*, March 2016, available at: http://budgetresponsibility.org.uk/docs/dlm_uploads/Devolved-taxes-forecast-1.pdf.

9 Section 25 of the Scotland Act 2012 defines a Scottish taxpayer as someone whose main place of residence in a given tax year is Scotland, or who spends most of that tax year living in Scotland. There are a number of specific cases whereby a taxpayer would always be deemed Scottish, for example if they are a Member of Parliament for a Scottish constituency. HMRC is responsible for the initial determination of whether or not someone is a Scottish taxpayer.

Remit of the Comptroller and Auditor General

10 Under section 80HA of the Scotland Act 1998 (the Act), as amended by the Finance Act 2014, the Comptroller and Auditor General (C&AG) is required for each financial year to prepare a report on:

- the adequacy of any of HMRC's rules and procedures put in place, in consequence of the Scottish rate provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions;
- whether these rules and procedures are being complied with;
- the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Scottish rate resolution; and
- the accuracy and fairness of the amounts reimbursed to HMRC as administrative expenses incurred as a result of the charging of income tax.

11 In discharging his remit under the Act, this is the C&AG's second report presented to the Scottish Parliament. Our first report on the administration of SRIT was in respect of the 2014-15 financial year, and was published in November 2015.[2] This report sets out HMRC's activities during 2015-16, prior to the introduction of the SRIT in April 2016 (**Figure 2** overleaf).

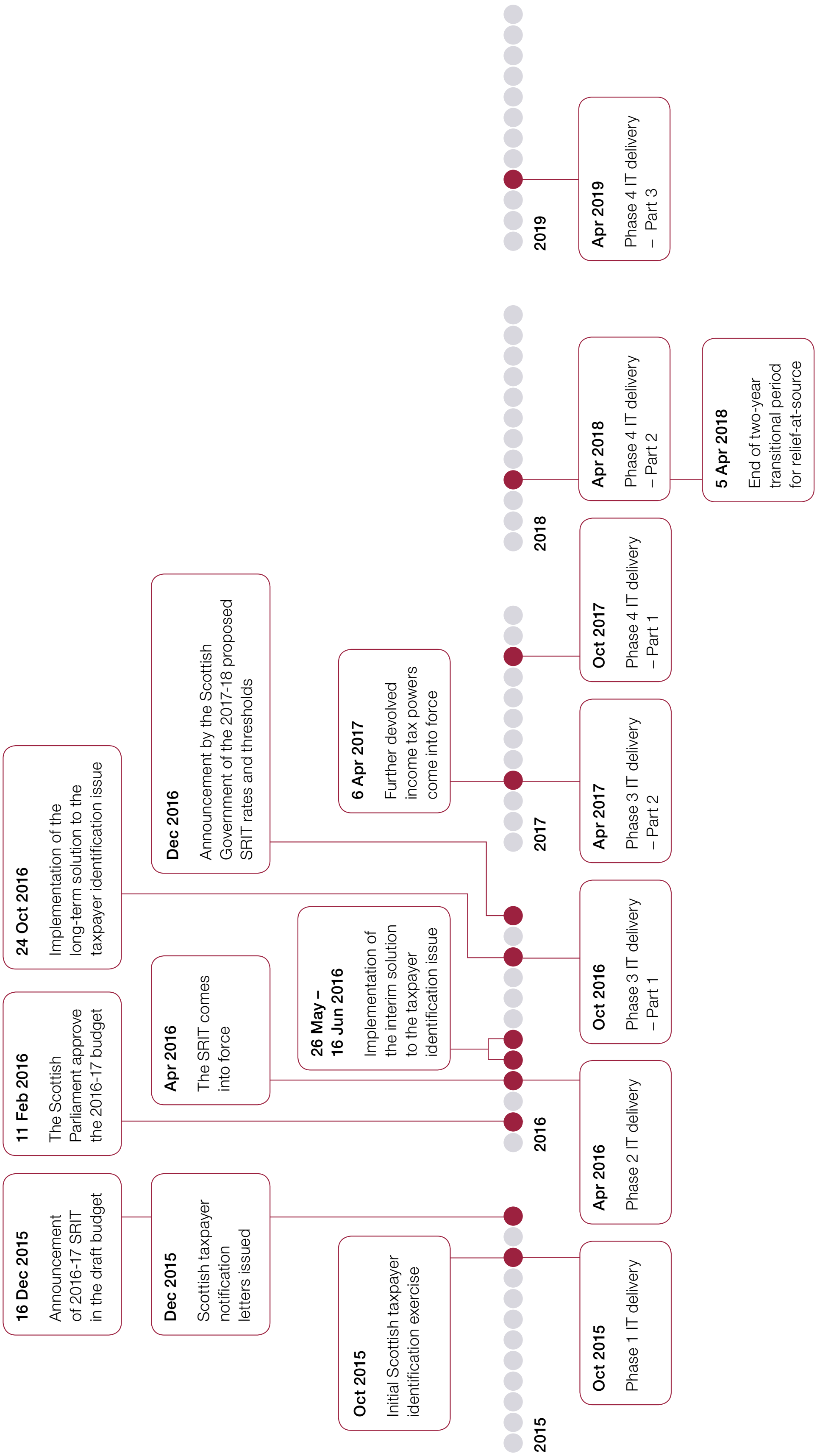
12 This report considers:

- whether the amounts reimbursed to HMRC by the Scottish Government are accurate and fair (Part One);
- the progress HMRC has made to date in setting up systems to ensure that income tax levied under the SRIT is assessed and collected properly (Part Two); and
- future challenges to the administration of SRIT (Part Three).

13 It does not consider the correctness of sums brought to account in relation to the SRIT or whether rules and procedures have been complied with. We will consider these matters in the third report, relating to activity in 2016-17, the first year of SRIT.

2 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2014-15*, Session 2015-16, HC 627, National Audit Office, November 2015, available at: www.nao.org.uk/wp-content/uploads/2015/11/The-administration-of-the-Scottish-Rate-of-Income-Tax-2014-15.pdf

Figure 2
Scottish Rate of Income Tax project – key events



Source: HM Revenue & Customs

Key findings

14 **The key challenge to HMRC's delivery of SRIT is maintaining and updating its record of address details in order to identify Scottish taxpayers.** Building on work undertaken in previous years to assure the accuracy of its initial Scottish taxpayer population, HMRC continues to mitigate this key risk. It is essential for HMRC to identify Scottish taxpayers and maintain a correct record of their addresses so that it can calculate accurately tax collected and the amount of revenue that the Scottish Government receives as part of its block grant in future years (paragraph 2.1).

15 **As a result of an error in the design of HMRC's taxpayer identification exercise in December 2015, 420,000 potential Scottish taxpayers did not receive a notification letter.** HMRC was notified quickly of this issue by other stakeholders, such as the Scottish Government, employers and taxpayers. HMRC engaged its IT supplier to investigate the issue in January 2016, and confirmed the total number of affected individuals in April 2016. The 420,000 omitted taxpayers received coding notices which informed them of the change in their annual tax code, and provided basic information on what was meant by an 'S' code. By not issuing the same level of information as the 2.45 million taxpayers originally identified in December 2015, HMRC may have created a less informed group of taxpayers (paragraphs 2.3 to 2.6).

16 **An interim solution was put in place by June 2016 to issue coding notices for the 2016-17 tax year to the 420,000 taxpayers omitted from the initial identification scan.** A permanent IT solution was then implemented in October 2016 to bring these taxpayers within HMRC's automated process for future years, and to ensure that all in-year changes of Scottish taxpayer status for these customers were correctly reflected in 2016-17 codes. We will assess the effectiveness of this approach in our next report, which will focus on 2016-17 activity (paragraphs 2.7 to 2.8).

17 **HMRC has undertaken specific analysis into high-risk areas within the taxpayer population.** HMRC has individually assessed all taxpayers with postcodes spanning the Scotland-England border; contacted all taxpayers with a Scottish correspondence address directly; and is in the process of cleansing incomplete Scottish addresses. This work has enabled HMRC to continue to refine their Scottish taxpayer population, following work undertaken in previous years to assure its initial accuracy (paragraph 2.10).

18 **HMRC's ability to assure the amount of tax collected for the Scottish Government will be undermined where taxpayers fail to update their address details.** HMRC should continue to communicate this key message to taxpayers. In 2015-16, HMRC spent £1,081,000 on communications with potential Scottish taxpayers about SRIT. HMRC has engaged with employers, agents and payroll specialists to raise awareness with key stakeholder groups. It has also conducted specific research with perceived 'high risk customer groups' to evaluate the effectiveness of its wider communication approach (paragraphs 2.11, 2.17 and 2.23 to 2.24).

19 A future divergence of tax rates or thresholds between Scotland and the rest of the UK presents the possibility of tax avoidance and evasion. HMRC's compliance strategy identifies the risk that taxpayers could either avoid SRIT, or pay the incorrect amount, because they: do not maintain their address; deliberately manipulate their address; or switch their income to capital receipts, for example through incorporation of a business. The strategy is specific to the different risk profile of three different groups of taxpayers: those with a net worth of £20 million; those earning over £150,000 annually or with a net worth of £1 million; and all other taxpayers. To date, HMRC has analysed the first of these three groups, which represents a small number of individuals, but proportionally a significant amount of tax at risk. The majority of compliance activity will commence in 2017-18. As part of its compliance strategy, HMRC has also conducted a baselining exercise to establish current rates of movement across the Scotland-England border, to enable analysis of any future increase in cross-border movement, and used its Large Business Unit to research the preparedness of large employers for the introduction of SRIT (paragraphs 2.27 to 2.32).

20 The ability to provide an IT solution allowing personal pension providers to claim relief at source continues to be a significant risk going forward. If tax rates between Scotland and the rest of the UK diverge, Scottish taxpayers will be due a different rate of relief at source on their personal pension contributions. From 2018, HMRC must notify pension providers of the correct rate of income tax for their scheme members to allow pension providers to apply the correct rate of relief at source. HMRC's most significant challenge in providing the correct taxpayer status is data matching. At present, the quality of pension providers' data is not sufficient to allow automatic data matching on the scale required. HMRC has strategies in place to mitigate these risks and is working closely with the pension industry to deliver the solution required for the relief at source system to accommodate the SRIT (paragraphs 3.3 to 3.5).

Conclusion

21 In order to administer the SRIT and ensure individuals pay the right amount of tax, HMRC must identify and maintain a complete and accurate record of the Scottish income taxpaying population. HMRC believes the IT solution it implemented in October 2016 is the long-term means of addressing issues that arose during 2015-16 that suggested its records of Scottish taxpayers were initially incomplete. If this solution works as intended, we believe this will be a significant step in HMRC being able to monitor and assure the accuracy of its Scottish taxpayer population. We will assess the effectiveness of its design and implementation in our next report.

22 There are other challenges ahead which HMRC are managing and which will become more significant when tax rates and thresholds differ between Scotland and the rest of the UK. HMRC must maintain accurate address information for Scottish taxpayers so that any potential for tax avoidance and evasion is mitigated. HMRC is also developing its financial reporting capability so that the actual amount of SRIT collected can be disclosed in its annual accounts, and providing an IT solution that allows private pension providers to claim relief at source. HMRC is currently making progress in tackling these challenges as planned. We will conclude on the correctness of sums brought to account by HMRC, and its continuing progress in administering SRIT, for the first time, in our 2016-17 report.

Part One

Costs incurred to date

1.1 The total cost incurred by HM Revenue & Customs (HMRC), and reimbursed by the Scottish Government, from the start of the Scottish Rate of Income Tax (SRIT) project in October 2012 to 31 March 2016, is £11.1 million. The costs reimbursed to HMRC by the Scottish Government relating to 2015-16 activity amounted to £8.4 million.[3] This consisted of staff costs of £1.3 million, IT costs of £5.6 million and non-IT costs of £1.5 million. **Figure 3** overleaf shows the cost breakdown against forecast.

1.2 We examined HMRC's methodology for estimating the costs of collecting and administering the SRIT for the year to ensure this was reasonable. On the basis of our procedures, the amount reimbursed by the Scottish Government for the year ended 31 March 2016 is fairly stated.

1.3 HMRC currently estimates the final total costs of implementing the SRIT project to be in the region of £30 million over the seven-year period from 2012-13 to 2018-19.[4] This is split between IT expenditure of £20 million and non-IT expenditure of £10 million, and does not include business-as-usual operational costs. This is an overall reduction of up to £5 million from last year's forecast.[5] The split of expenditure has also shifted, with IT expenditure now expected to be £5 million higher and non-IT expenditure expected to be £10 million lower than last year's forecast.

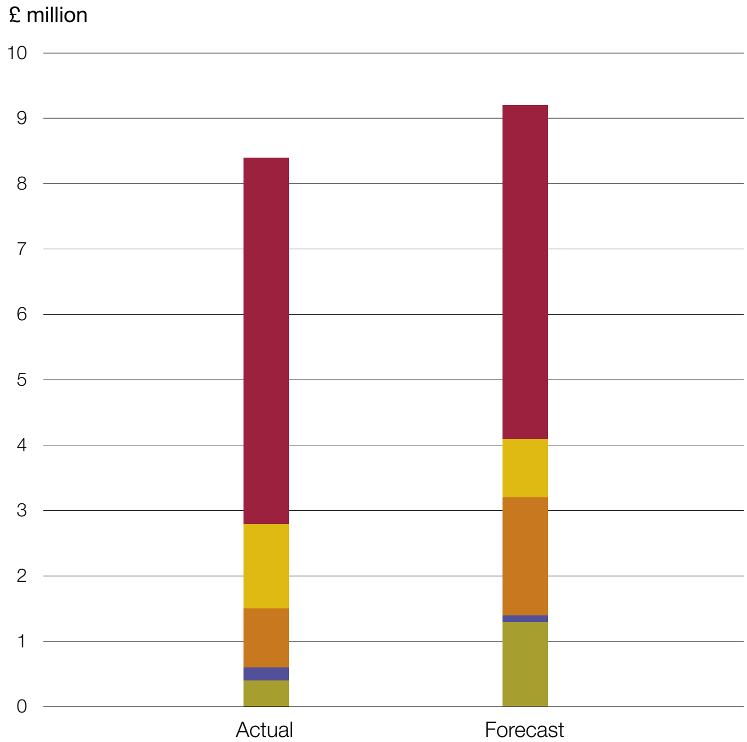
1.4 HMRC manages separate projects for SRIT, Further Scottish Income Tax Powers (FSITP) and relief at source (RAS). In 2015-16, most costs incurred were in respect of the SRIT project. However, HMRC's forecast expenditure for future years shows the SRIT project becoming business as usual, and the FSITP and RAS projects incurring significantly more expenditure (Part Three). For the purposes of our report, we have assessed the reasonableness of all costs incurred by HMRC and subsequently reimbursed by the Scottish Government.

3 HM Revenue & Customs, *Annual Report and Accounts 2015-16*, July 2016, available at: www.gov.uk/government/publications/hmrc-annual-report-and-accounts-2015-to-2016

4 June 2016 estimate.

5 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2014-15*, Session 2015-16, HC 627, National Audit Office, November 2015.

Figure 3
Actual spend against forecast spend, 2015-16



	Actual	Forecast
IT and Digital	5.6	5.1
HMRC staff	1.3	0.9
Postage	0.9	1.8
Communications	0.2	0.1
Other	0.4	1.3
Total	**8.4**	**9.2**

Notes

1 Actual 'Other' includes £30,000 that was spent on 'promote and prevent' compliance activity.

2 Actual spend was lower than forecast mainly as a result of lower than expected postage costs.

Source: HM Revenue & Customs

Part Two

Progress made in administering the Scottish Rate of Income Tax

Initial identification of Scottish taxpayers

2.1 Identifying Scottish taxpayers has been, and continues to be, HM Revenue & Customs' (HMRC's) greatest challenge in delivering the Scottish Rate of Income Tax (SRIT) project successfully. HMRC's SRIT risk register recognises that "the project may not be able to identify an acceptable strategy and approach for identifying the potential Scottish taxpayer population" as its single highest risk to delivery for the duration of the project.

2.2 As we highlighted in our 2014-15 report, there is no independent record of the Scottish population for HMRC to compare its Scottish taxpayer dataset with.[6] HMRC's national statistics show that there were 2.6 million Scottish taxpayers in 2013-14.[7] This figure has been fundamental to HMRC's strategy for identifying Scottish taxpayers. HMRC believes that it is an accurate estimate of current Scottish taxpayers and has given this figure to the Scottish Government.

2.3 HMRC's strategy for identifying Scottish taxpayers involved using a taxpayer's postcode to identify whether they lived in Scotland or elsewhere in the UK. To implement this, HMRC scanned all the individual records within its database in October 2015. The scan added a Scottish flag to records with a Scottish postcode, identifying 4,965,840 records as Scottish. HMRC sent Scottish taxpayer notification letters to 2,453,763 individuals at the start of December 2015. These people either had a live pay-as-you-earn (PAYE) employment record with earnings over the personal allowance in 2014-15 or a live self-assessment record. The total number was 6% less than HMRC's estimate of 2.6 million which it considered to be within an acceptable tolerable difference.

2.4 HMRC discovered that the scan was incomplete following contact by members of the Scottish Government and the public who had not received, or knew people who had not received, Scottish taxpayer notification letters. On 8 January 2016, HMRC identified a specific case that illustrated that the parameters it initially used to identify Scottish taxpayers had led to an incomplete population. The parameters of the scan were set to flag Scottish residential addresses verified by the Royal Mail Postcode Address File (PAF). However, many addresses held by HMRC are classified as 'as input', where an individual's address has been entered without using the PAF verification facility.

6 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2014-15*, Session 2015-16, HC 627, National Audit Office, November 2015.

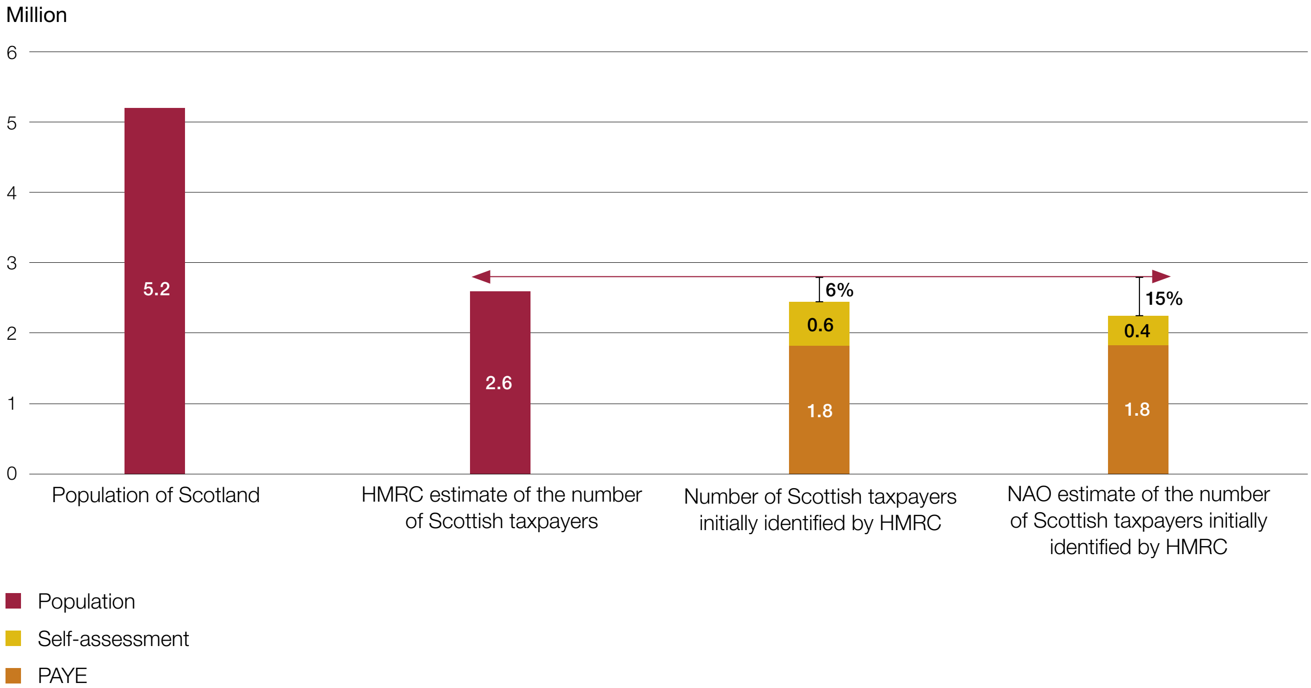
7 HM Revenue & Customs, *Survey of Personal Incomes 2013-14*, available at: www.gov.uk/government/collections/personal-incomes-statistics (available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/510864/Table_3_13_14.xlsx).

2.5 HMRC engaged its IT supplier to determine the scale of the issue on 20 January 2016. The work was completed in April 2016 and revealed that approximately 850,000 records with a Scottish postcode were not flagged as Scottish by the initial scan in October 2015. HMRC's analytical team then estimated that 420,000 of the 850,000 Scottish records omitted were potential Scottish income taxpayers who should have received a Scottish taxpayer notification letter (**Figure 4**).

2.6 HMRC did not have effective controls in place to immediately recognise that the full intended population had not received a Scottish taxpayer notification letter. The population HMRC identified included a proportion of individuals not expected to pay income tax, as not all of those with a live self-assessment record will end the year with a tax liability. For example, approximately 10 million people in the UK submitted a self-assessment return for 2013-14, but only 68% of those had a tax liability. Therefore, the number of Scottish taxpayers identified was approximately 199,000 more than HMRC planned for. We estimate that the number of Scottish taxpayers HMRC actually identified through its initial identification exercise was 2.25 million – sufficiently below the 2.6 million estimate to raise immediate questions about the completeness of the population (Figure 4).[8]

Figure 4
Scottish taxpayer population

HMRC estimated that 420,000 taxpayers did not receive Scottish taxpayer notification letters



Note
1 Scotland population is based on 2011 Census

Source: HM Revenue & Customs data; Office for National Statistics, UK Census, 2011

8 Calculated as: 1,831,148 pay-as-you-earn taxpayers plus 68% of 622,615 self-assessment taxpayers.

2.7 HMRC implemented an interim solution to rectify the identification issue by the end of June 2016, six months after the initial identification exercise. Between 26 May and 16 June 2016, Scottish flags were added to all records previously omitted. Those identified through this process received a P2 coding notice, which informed them that their tax code was now prefixed with an 'S', and what this signified. Unlike in December 2015, Scottish taxpayer notification letters were not issued to those individuals affected (paragraph 2.21). As the tax code notices were issued through business-as-usual processes, HMRC cannot distinguish between those issued as a result of this exercise and those issued due to other unrelated changes in circumstances. Therefore, it does not know the exact number of additional Scottish taxpayers identified through this exercise.

2.8 HMRC's long-term solution was to implement an IT fix to ensure both 'as input' and PAF verified addresses were used to determine Scottish taxpayer status. The implementation date was 24 October 2016 as part of HMRC's biannual IT release. The solution will bring the taxpayers originally omitted from the identification exercise into HMRC's automated process for future years, and ensure that all in-year changes of Scottish taxpayer status for these customers were correctly reflected in 2016-17 codes. We will assess the effectiveness of this approach in our next report, which will focus on 2016-17 expenditure and activity. HMRC should continue with its assurance work to ensure that the issue has been fully resolved and residency rules are working as expected.

2.9 In our 2014-15 report, we noted the positive work HMRC had undertaken in testing the reasonableness of its taxpayer population data, in order to establish a taxpayer population. We asserted the data matching exercises undertaken in 2014-15 gave HMRC and the Scottish Government some assurance over the initial identification of the Scottish taxpayer population.

2.10 HMRC has been proactive in undertaking additional work to refine the way it identifies the Scottish taxpayer population and provide additional assurance in the following areas:

- **Border cases:** HMRC analysed the six postcodes that span the Scottish–English border and introduced a manual process to manage the 85 potential taxpayers that live within these postcodes.
- **Correspondence addresses:** In December 2015, HMRC sent 2,144 letters to the Scottish correspondence address of those customers who also had a residential address in another part of the UK.
- **Scottish electoral roll-mismatches:** In January 2016, HMRC sent 14,391 letters to individuals with a Scottish address on the electoral roll where HMRC's records showed an address in another part of the UK.
- **Incomplete addresses:** HMRC identified 50,801 cases under three scenarios: postcode field is blank but a valid postcode is held in one of the other address fields; postcode is invalid but the postcode field (first two letters) is one of the Scottish areas; postcode field is blank but a key word appears in address lines two to five, for example 'Glasgow'. HMRC is going to engage with Transactis Ltd. to correct addresses where possible.

- **Duplicates:** HMRC's analytical team estimates that the Scottish taxpayer population includes between 12,000 and 19,000 duplicate records. HMRC is planning to assign operational staff to cleanse and merge duplicate records.

Maintenance of addresses

2.11 Accurate addresses are vital to delivering the SRIT project successfully, and collecting and assessing the right amount of tax from Scottish taxpayers. Individual taxpayers are responsible for notifying HMRC of a change of address; therefore, it is essential for HMRC to continually convey this message to taxpayers. HMRC forecasts no further expenditure on SRIT-specific communications, but will continue to use non-paid for channels including communications with agents and employers to reinforce the message that it is important to keep address details up to date. This will only become established taxpayer behaviour with a sustained communication campaign over future years.

2.12 The Personal Tax Account (PTA) is key to HMRC's Making Tax Digital strategy. PTAs should make it easier for taxpayers to engage with their tax affairs, and maintain their personal details. Since January 2016, over 5 million taxpayers across the UK have registered for a PTA.[9] HMRC's use of Real Time Information (RTI) data to maintain accurate taxpayer addresses is limited at this stage. From April 2015, HMRC began using RTI Full Payment Submissions that reported a change of address to allow employee records on HMRC systems to be updated. However, employers are only required to submit an employee's address if the employee is new or they do not know the employee's National Insurance number.

IT delivery

2.13 HMRC's phased IT delivery plan began in November 2014 and is due to be completed in April 2019. Phases 1 and 2 took place between October 2015 and April 2016. They included developing the capability to assess residency periods for individuals, allowing HMRC to identify Scottish taxpayers, as well as introducing necessary changes to enable the use of the 'S' tax code.

2.14 Some employers were initially unable to download 'S' codes due to an omission in the testing process undertaken by HMRC and its IT supplier. Employers contacted HMRC to say that they had not received 'S' tax codes as expected. HMRC identified that those employers using the Data Provisioning Service to access coding notices, notifications and reminders had received tax codes without the 'S' attached. HMRC estimates that 80,000 employers were affected by this issue. HMRC fixed the problem in March – prior to the start of the 2016-17 tax year – then used April 2016 RTI data to carry out assurance testing to ensure that employers had applied the reissued 'S' tax codes. This demonstrated that the 'S' code has been correctly applied in all cases tested.

9 HM Revenue & Customs, *'More than 5 million customers are using HMRC's Personal Tax Account'*, 22 September 2016, available at: www.gov.uk/government/news/more-than-5-million-customers-are-using-hmrcs-personal-tax-account

2.15 Phase 3 of the IT delivery is due to take place from October 2016 to April 2017. The most significant items to be delivered within this phase are:

- development of financial accounting data to ensure that HMRC captures accurately the Scottish element of income tax amounts paid; and
- the creation and collection of business intelligence data for the Scottish Government.

2.16 HMRC is defining the requirements for financial accounting with IT suppliers and liaising with the Scottish Government to agree the content and format of the management information to be provided. Phase 4 is scheduled for October 2017 to April 2019. It will include the necessary changes to enable personal pension providers to claim relief at source (Part Three).

Communications strategy

2.17 HMRC's communications strategy targeted stakeholders through a variety of platforms (**Figure 5** overleaf). HMRC spent £1.1 million in total on communications in 2015-16. This was divided between £924,000 of postage costs, and £157,000 of other communications expenditure. While further communication through a variety of non-paid-for channels is expected, there is no further specific communications expenditure on SRIT planned from 2016-17 onwards.

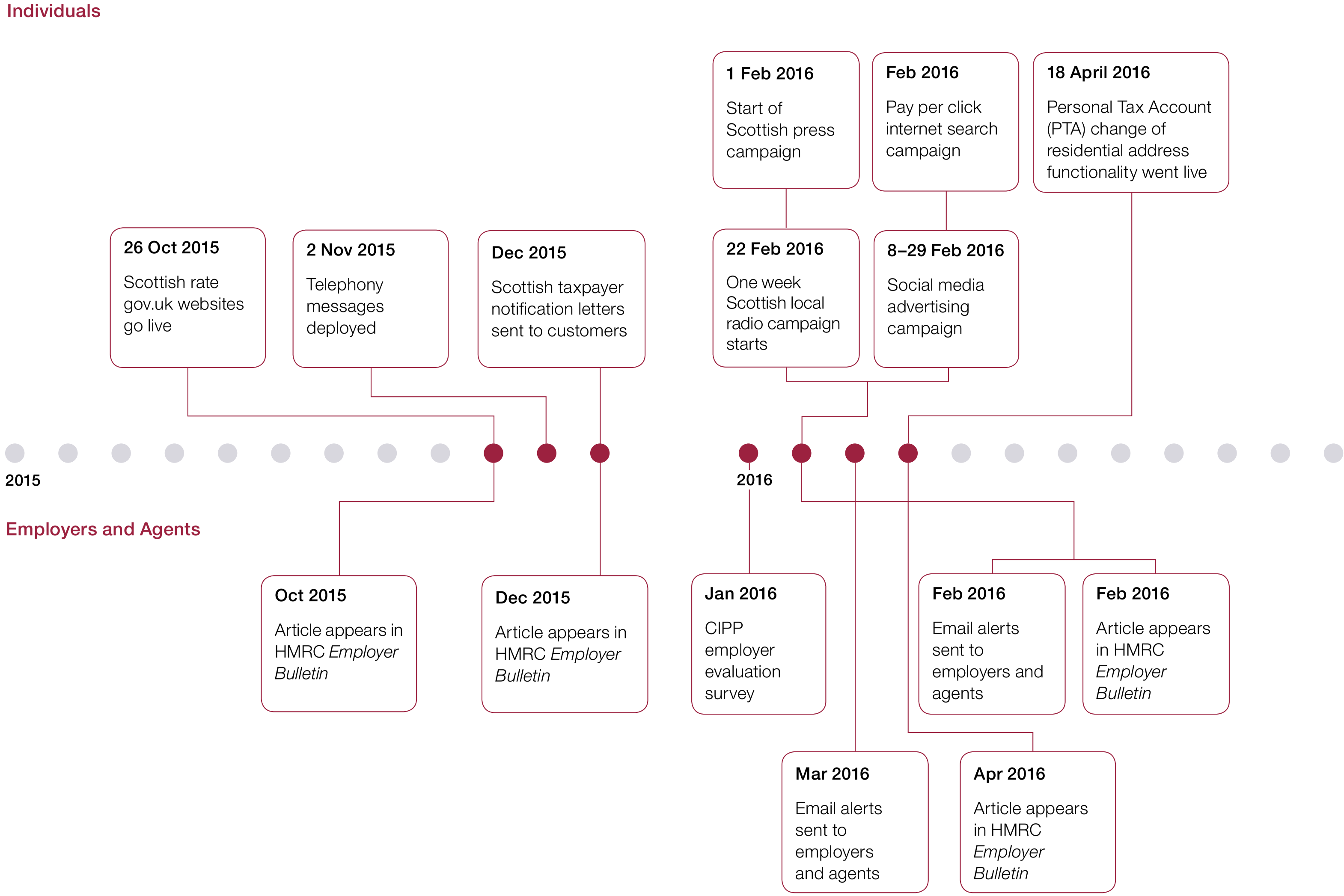
Direct communication with taxpayers

2.18 The most costly (£924,000) and important aspect of the communications strategy was the Scottish taxpayer notification letter. As stated in paragraph 2.3, HMRC issued 2.45 million letters in early December 2015 to those it identified as potential Scottish taxpayers through the initial identification exercise. The letter informed recipients of the action they needed to take if the address information held by HMRC was incorrect (example letter at Appendix One).

2.19 The Scottish taxpayer notification letters were an important means of helping HMRC to refine its data on Scottish taxpayers. HMRC's focus was on re-assuring taxpayers no action was required of them apart from to contact HMRC if their address information was incorrect or if they were incorrectly flagged as a Scottish taxpayer. However, as highlighted in our 2014-15 report, HMRC's strategy was to minimise telephone contact from recipients of the letter. HMRC did not include a contact telephone number on the letter; instead, it directed customers to relevant gov.uk addresses where they could find out more about SRIT. The Scottish taxpayer notification letters provoked a very low response rate. HMRC only recorded 312 calls from customers between 1 December 2015 and 20 January 2016 specifically in respect of SRIT.

2.20 HMRC analysed website traffic during the period Scottish taxpayer notification letters were expected to be received by customers (**Figure 6** on page 19). Based on this data, there was no noticeable increase in the traffic to HMRC's change of details webpage as a result of the Scottish taxpayer notification letters.

Figure 5
Communications strategy timeline



Note

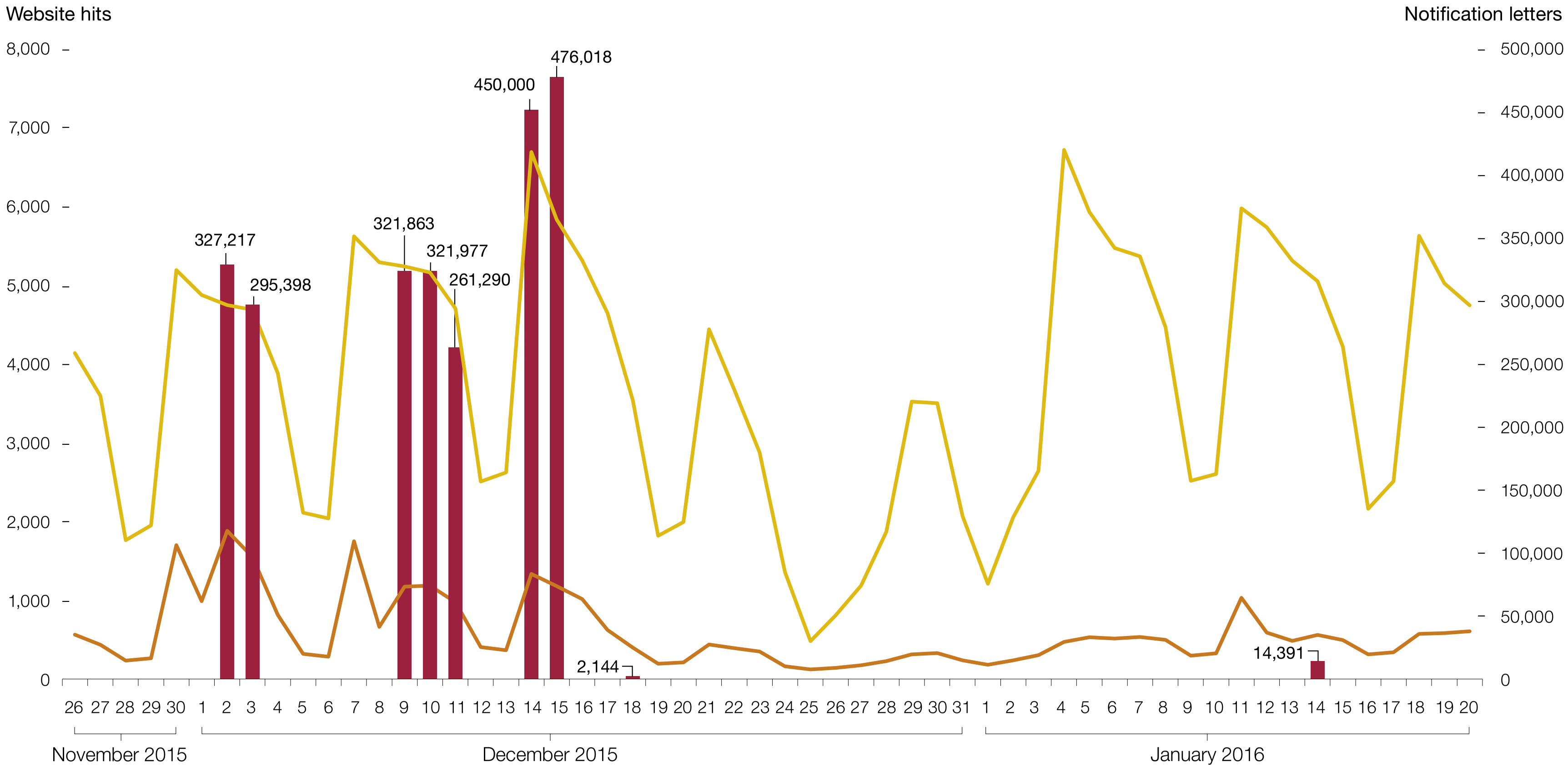
1 CIPP = Chartered Institute of Payroll Professionals.

Source: HM Revenue & Customs

Figure 6

Volume of Scottish taxpayer notification letters and website traffic

A notable increase in traffic to HMRC's change of details website was not generated by the Scottish taxpayer notification letters



■ Scottish taxpayer notification letters expected to be received by customers

— Hits on "tell HMRC about a change to your personal details" webpage

— Hits on SRIT webpage

Note

1 The trajectories of number of hits on HMRC's change of details webpage (yellow line) and the number of hits on the SRIT webpage (orange line) have not noticeably changed as a result of the letters received by taxpayers (in red).

Source: National Audit Office analysis of HM Revenue & Customs Data

2.21 HMRC did not communicate directly with those taxpayers incorrectly excluded from the December 2015 mailshot (paragraph 2.7). This taxpayer group instead received coding notices informing them of the change in their annual tax code, along with a basic explanation of what an 'S' prefix to an individual's tax code signifies. These did not contain specific guidance to taxpayers on the importance of HMRC having their correct address information to ensure they pay the right amount of tax.

Mass communication

2.22 HMRC ran a media campaign in February 2016, which included the Scottish national press, Scottish local radio, a pay-per-click internet search campaign and a boosted social media presence. The aim of the media campaign was to promote key messages, supplement the information given in the Scottish taxpayer notification letter and engage with and raise awareness among those who did not receive direct contact from HMRC.

2.23 HMRC identified three high-risk customer groups as the target of the media campaign: students, recent movers and those living in border areas. GfK UK was commissioned to evaluate the campaign. The evaluation found that all three groups agreed that the advertisement told them something worth knowing (74%, 57% and 48% respectively). While the advertisement was not seen as particularly engaging or memorable, it did have an impact in prompting a call to action. Over half of the sample of students (60%) and recent movers (58%) contacted said that they intended to take action after seeing the advertisement, including checking that HMRC had their correct address and looking for more information about SRIT.

2.24 HMRC also engaged with employers, agents and payroll specialists. It held face-to-face fora and presentations with employers and agents from across the UK and the Scottish public sector. HMRC used the employer fora and presentations to identify themes to be addressed in employer bulletins. Employer bulletins distributed throughout 2015-16 have been the most direct and effective communication tool with this key stakeholder group.

2.25 The Chartered Institute of Payroll Professionals, alongside HMRC, carried out an employer evaluation survey during January 2016. Survey results from the 69 organisations (employers, agents and payroll service providers) that took part indicated that their general awareness of SRIT was high. In particular:

- 97% of respondents knew that the tax code for a Scottish taxpayer would start with an 'S'; and
- 73% of respondents felt they had sufficient information to prepare for the introduction of SRIT.

2.26 However, 91% of respondents also stated that they had not received any queries regarding the SRIT from their workforce. These results are consistent with the insights gained during the face-to-face forum held with around 60 Scottish public sector employers in January 2016. Employee contact with both employers and HMRC in relation to SRIT therefore appears to have been low up to this point.

Compliance activity

2.27 Any divergence in rates or thresholds between Scotland and the rest of the UK introduces the risk of tax avoidance and evasion. Even if there was no disparity between Scotland and the rest of the UK, and therefore no potential tax advantage to taxpayers, the Scottish Government still needs to know the accurate value of tax revenue collected from Scottish taxpayers as this has a direct impact on the adjustment to the Scottish block grant.

2.28 Non-compliance is likely to fall into one of three categories:

- customer error due to not maintaining their address;
- deliberate address manipulation; or
- income to capital switching by taxpayers.

2.29 HMRC produced a compliance strategy in June 2015 and spent some £30,000 on SRIT-specific compliance activity in 2015-16. For self-assessment taxpayers, the strategy focuses separately on high net worth individuals (with a net worth of £20 million), affluent individuals (earning over £150,000 annually, or with a net worth of £1 million) and all other taxpayers.[10] For PAYE, the strategy has focused mainly on large businesses and public bodies groups. HMRC's compliance strategy is centred on a three-stage process:

- **Promote** good compliance: This has been carried out mainly through the communications activity outlined in paragraphs 2.17 to 2.26 to raise awareness of SRIT and the importance of keeping HMRC informed of new address information.
- **Prevent** non-compliance: Activity has focused on work carried out by HMRC's High Net Worth Unit and Large Business Unit, as detailed in paragraphs 2.30 and 2.31. In addition, from 2016-17, HMRC will prepopulate individuals' Scottish status within self-assessment forms. It will contact customers when it receives address data from employers and the Department for Work & Pensions if it suspects that a customer has moved.
- **Respond** to tax risks: Activity has been minimal due to the effective rates of income tax remaining the same between Scotland and the rest of the UK. HMRC has started to track cross-border migration trends and intends to monitor changes to self-assessment forms.

10 The classification of a high net worth individual was reduced from a wealth of £20 million to £10 million in July 2015. HMRC's analysis has been based on the original threshold of £20 million.

2.30 HMRC's compliance activity has focused on preventing non-compliance. Most notably, this has involved analysing high net worth individuals in Scotland, and the potential for a change in behaviour if the income tax rate in Scotland diverges from that of the rest of the UK. HMRC has established a bespoke team in East Kilbride to deal specifically with these Scottish customers. High Net Worth Unit customers are allocated a customer relations manager for one-to-one engagement.

2.31 HMRC has also undertaken research on employer understanding, business readiness and appetite for tax planning in advance of the introduction of SRIT. This work has been carried out by its Large Business Unit, which targets approximately 2,000 of the UK's largest and most complex employers. Research has shown that 75% of large businesses have a workforce that is partially Scottish. HMRC must continue to raise awareness with the remaining 25% so that these employers understand their responsibilities if their workforce changes.

2.32 Apart from dedicated work on the small number of high net worth individuals in Scotland, HMRC's 'respond' activity for most of the Scottish income taxpaying population will be in line with its UK-wide compliance strategy. There is a risk that this broad approach will result in non-compliance going undetected if HMRC's taxpaying population is not complete and accurate. HMRC's 'promote' message on updating addresses is key for this behaviour to be adopted by affected taxpayers.

Governance

Project governance

2.33 The governance structure was constructed to reflect the partnership between HMRC and the Scottish Government and facilitates regular communication. The Scotland Act Programme Board is accountable for delivering the implementation programme and oversees progress of the SRIT project. The Programme Board scrutinises costs to ensure that the project achieves value for money. The Project Board reports to the Programme Board and is responsible for ensuring that the policy solutions for implementing the SRIT are delivered successfully. Scottish Government and HMRC representatives attend both the Programme and Project Boards.

2.34 A Risk Review Board is also in place. This is essentially a subcommittee of the Project Board, with specific responsibility for monitoring and assessing project risks. The governance structure was outlined in detail in our 2014-15 report, and has not significantly changed.[11]

11 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2014-15*, Session 2015-16, HC 627, National Audit Office, November 2015.

2.35 In the lead-up to the introduction of the SRIT in April 2016, HMRC arranged three checkpoints to allow the Scottish Government to challenge and approve HMRC's progress. These were scheduled for November 2015 and January and March 2016. When taxpayer identification issues emerged, additional checkpoints were introduced in April and July 2016, with a further checkpoint taking place in November 2016 following HMRC's implementation of the long-term solution.

2.36 The SRIT project has been reviewed several times using the Office of Government Commerce (OGC) gateway process. The most recent review, OGC Review 4, took place in March 2016. The review team concluded that it had confidence that the mitigation actions and plans developed would fully resolve the taxpayer identification issue. Two significant challenges to the successful delivery of relief at source were also identified: engagement with the pension industry; and the quality of data owned and supplied by the pension industry. Relief at source is discussed further as a future challenge to the administration of SRIT in paragraphs 3.3 to 3.5.

2.37 The OGC review made six recommendations – including one critical recommendation – to apply an open and transparent process of engaging and sharing information with the Scottish Government on how it has resolved the taxpayer identification issue.

2.38 HMRC's internal audit function has reported twice on the SRIT project in previous years, with a further report commissioned in April 2016. The results of this report were not available at the time of reporting.

Management information

2.39 The Scottish Government requires access to sufficient data to hold HMRC to account for its performance in administering the SRIT, as well as to allow accurate income forecasting and to ensure that it receives the correct amount of tax collected. The memorandum of understanding between HMRC and the Scottish Government on the operation of the SRIT set out that both parties would agree a set of service standards. HMRC is currently developing, in collaboration with the Scottish Government, a business intelligence report to be provided on a quarterly basis. The Scottish Government was due to receive the first report in October 2016.

2.40 This quarterly report will include:

- in-year changes to the number of Scottish records;
- Scottish records where letters have been returned to sender;
- customer contact: calls, post and complaints; and
- gov.uk web-hits.

The report will not provide snapshots of Scottish taxpayer volumes.

2.41 The financial reporting relating to the value of tax collected through SRIT will be included and reviewed as part of HMRC's 2016-17 Trust Statement. HMRC and the Scottish Government are working to agree the format and process of sharing information on tax receipts in year. Similarly, HMRC and the Scottish Government are working to agree the manner and frequency with which compliance performance will be reported.

Part Three

Future challenges

Further Scottish income tax powers

3.1 From 2017-18, the Scottish Parliament will have the power to set the rates of income tax and the thresholds at which these are paid for the non-savings and non-dividend income of Scottish taxpayers. The UK Government retains responsibility for setting the personal allowance; however, a zero rate band could be introduced to increase the level of personal allowance for Scottish taxpayers.

3.2 HM Revenue & Customs (HMRC) has a dedicated project team in place to implement the further devolved powers set out within the Scotland Act 2016. HMRC must implement further IT changes to make systems more flexible so that it can update rates and thresholds more easily. This flexibility will help it to manage the inevitably tight time frame between the announcement of tax rates and thresholds by the Scottish Government in its annual budget and the start of the following tax year. HMRC will need to ensure that the transition from the Scottish Rate of Income Tax (SRIT) project to the Further Scottish Income Tax Powers project is managed effectively.

Relief at source

3.3 Pension contributions are tax exempt. Personal pension contributions are made after tax, and the pension scheme administrator (PSA) claims relief at source (RAS) from HMRC. Scottish taxpayers will be due different basic rates of RAS on their pension contributions compared to taxpayers elsewhere in the UK should basic rates diverge.

3.4 Ministers agreed to a two-year transitional period (2016-17 and 2017-18) to allow the pension industry to prepare its systems for the SRIT. During this period, the pension industry will continue to apply the standard UK rate of income tax to all scheme members. If the Scottish rate differs from the rate for the rest of the UK in 2017-18, HMRC will be responsible for calculating and reconciling any RAS shortfall or excess payment given by pension providers to Scottish taxpayers. From 2018 onwards, HMRC will notify pension providers of the correct rate of income tax for their scheme members, allowing pension providers to apply the correct rate of RAS.

3.5 Two of the three significant risks on HMRC's SRIT risk register are associated with relief at source. The ability to provide an IT solution allowing personal pension providers to claim relief at source continues to be a significant risk going forward. Similarly, a significant challenge to HMRC successfully providing the correct taxpayer status is data matching. HMRC's estimates suggest that there is a 4% non-matching rate due to errors in, or omission of, National Insurance numbers on pension provider returns. It is mitigating this risk by engaging with pension providers to communicate the implications of poor data quality.

Appendix One

Scottish taxpayer notification letter

1 Scottish taxpayer notification letter issued to 2.45 million individuals in December 2015 (overleaf).

HM Revenue
& Customs

REPRINT-REFERENCE--X 999

RECIPIENT_NAME_LINE_1_MAX_35_CHARSX
ADDRESS_LINE_1_MAX_35_CHARSXXXXXXXX
ADDRESS_LINE_2_MAX_35_CHARSXXXXXXXX
ADDRESS_LINE_3_MAX_35_CHARSXXXXXXXX
ADDRESS_LINE_4_MAX_35_CHARSXXXXXXXX
ADDRESS_LINE_5_MAX_35_CHARSXXXXXXXX
POSTCODEXX

Date
DD_MonthXXXXXXX_YYYY

Dear Recipient_Name_Max_35_CharsXXXXXXXX

You have received this letter as our records show you as Capacitor_Type_Max_35_CharsXXXXXXXX for TaxpayersName_Max_35_CharsXXXXXXXXX.

The Scottish rate of Income Tax

From 6 April 2016, if you live in Scotland, some of your Income Tax will be paid to the Scottish Government. This is a change from the current system, where all Income Tax is paid to the UK Government to fund spending across the UK. **We are writing to you because we need to confirm that we have the correct address for you, so that you pay the right amount of tax**.

For the vast majority of people, whether you are a Scottish taxpayer is based on where you live. Our records show that you are a UK taxpayer and your main residence is in Scotland. This means that the new Scottish rate of Income Tax will apply to you. If you're employed or receive a pension, from next year your tax code will begin with an S.

The Scottish Government will publish its Draft Budget on 16 December 2015. This will include its proposals for the Scottish rate of Income Tax, which may affect the amount of tax you pay from April 2016. You will be able to find out this rate at **www.gov.scot/incometax**

Do I need to do anything?

There is no action for you to take, unless you need to get in touch with us because your main residence isn't in Scotland, or to let us know your new address if you move home. To do this, go to **www.gov.uk/tell-hmrc-change-of-details** Your Income Tax will continue to be collected in the same way as it is now from your pay or pension.

More information

If you need more information about how the Scottish rate affects you (for example, because you have more than one address, you're a student, or a mobile or offshore worker) or you just want to work out how much tax you'll pay after the rate is announced, go to **www.gov.uk/scottishincometax**

Yours sincerely,

Ruth Owen

Personal Tax Director General

HMRC 10/15

This report has been printed on Evolution Digital Satin and contains material sourced from responsibly managed and sustainable forests certified in accordance with the FSC (Forest Stewardship Council).

The wood pulp is totally recyclable and acid-free. Our printers also have full ISO 14001 environmental accreditation, which ensures that they have effective procedures in place to manage waste and practices that may affect the environment.

National Audit Office

£10.00

ISBN 978-1-78604-093-0

9 781786 040930

Design and Production by NAO External Relations
DP Ref: 11400-001