



National Audit Office

Report

by the Comptroller
and Auditor General

HM Revenue & Customs

The administration of the Scottish rate of Income Tax 2016-17

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The administration of the Scottish rate of Income Tax 2016-17

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This report considers the administration of the Scottish rate of income tax in 2016-17.

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

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Key facts

2.6m

estimated number
of Scottish income
taxpayers in financial
year 2016-17

£4.6bn

estimated amount of
income tax paid under
the Scottish rate of
income tax in 2016-17

0%

difference in rates
between Scottish and
UK income tax in 2016-17

£6.3 million administrative cost to HM Revenue & Customs of running
the Scottish rate of income tax and related projects in 2016-17

386,000 estimated number of Scottish taxpayers expected to pay the higher
rate of income tax in 2017-18

£127 million estimated amount of extra tax that Scottish taxpayers will pay
in 2017-18

Summary

Introduction: powers and accountability

1 The Scotland Act 2012 reduced UK income tax rates in Scotland by 10 percentage points and gave the Scottish Parliament the power to set a Scottish rate of income tax. This applies to non-savings, non-dividend income only. The Scottish Government received the income tax revenue generated from the Scottish rate.

2 The rates of income tax were consistent across the UK in 2016-17 at 20% (basic rate), 40% (higher rate) and 45% (additional rate). In Scotland, these rates were reduced by 10 percentage points, and the Scottish Parliament used its powers to set a Scottish rate of 10% across all tax bands, effectively matching the rates in the rest of the UK at 20%, 40% and 45%.

3 The Scottish Parliament's tax-raising powers were enhanced by the Scotland Act 2016. From 2017-18, the Scottish Parliament has full power to determine the rates and thresholds (excluding the personal allowance) paid by Scottish taxpayers (**Figure 1** overleaf).¹ This means it can choose to maintain or vary the rates used in the UK, and also apply these rates to a wider or narrower range of incomes.

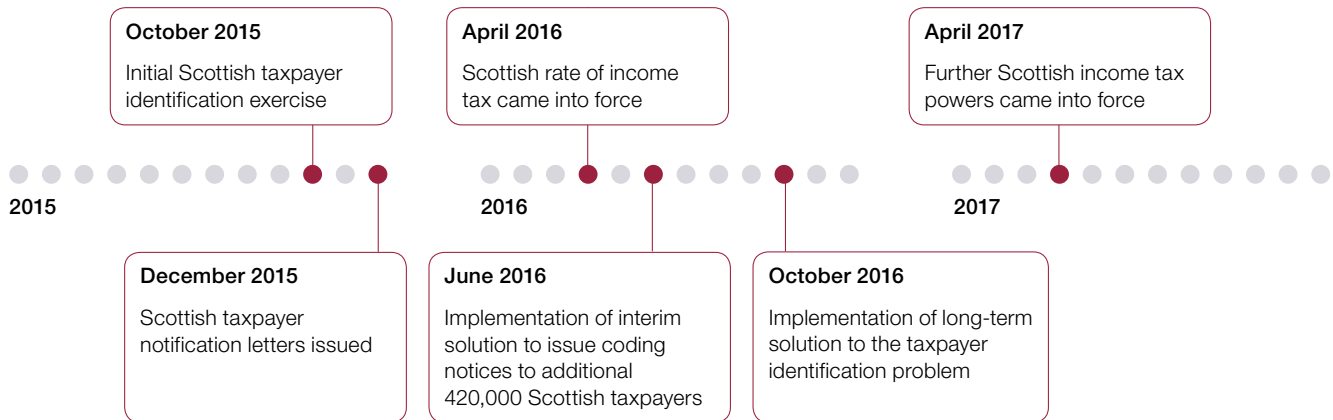
4 In 2017-18, income tax rules in Scotland differ from the rest of the UK for the first time. Scottish taxpayers will pay the higher rate of tax (40%) as soon as they earn £43,000 – as opposed to £45,000 in the rest of the UK. There are no other areas where the UK and Scottish income tax regimes diverge.

5 HM Revenue & Customs (HMRC) continues to administer and collect Scottish income tax as part of the UK tax system. It passes Scottish income tax to HM Treasury as it does for all other tax receipts. Taxpayer records with Scottish addresses are identified in HMRC's systems by a flag which indicates they are subject to Scottish income tax rates and thresholds.

¹ A threshold is the point at which a taxpayer starts to pay a different rate of tax.

Figure 1
Timeline of key events

The Scottish rate of income tax was introduced in April 2016



Source: National Audit Office

Remit of the Comptroller and Auditor General

6 Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014, requires the Comptroller and Auditor General to prepare a report for each financial year 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 which are reimbursed to HMRC as administrative expenses incurred as a result of the charging of income tax.

7 This is his third report, which is presented to the Scottish and UK parliaments. Our first report covered the 2014-15 financial year, and was published in November 2015.² Our second report covered the 2015-16 financial year and was published in December 2016.³

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.

³ Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2015-16*, Session 2016-17, HC 871, National Audit Office, December 2016.

8 This report considers:

- the collection of income tax from Scottish taxpayers (Part One);
- HMRC's estimate of income tax attributable to the Scottish rate of income tax in 2016-17 (Part Two);
- challenges in collecting tax from Scottish taxpayers (Part Three); and
- the cost of administering Scottish income tax, including whether the amounts repaid to HMRC by the Scottish Government are accurate and fair (Part Four).

Appendix One sets out our audit approach and methodology.

Key findings

Administering the Scottish rate of income tax

9 HM Revenue & Customs has identified approximately 2.6 million Scottish taxpayers. HMRC has undertaken significant work in previous years to assure the accuracy of its Scottish taxpayer population. In our 2015-16 report, we highlighted that 420,000 taxpayers had not received an initial notification letter in December 2015 confirming their status as a Scottish taxpayer. HMRC has now rectified the error that caused this, and undertaken checks to validate the new process. These checks established that HMRC systems are now able to correctly flag Scottish taxpayers based on the address data they hold (paragraph 3.3).

10 An estimated 386,000 Scottish taxpayers will pay the higher rate of income tax in 2017-18. The higher rate of income tax applies to non-savings and non-dividend income above £43,000 in Scotland. Taxpayers in the rest of the UK will pay the higher rate of tax on income over £45,000. HMRC does not expect that the difference between Scotland and the rest of the UK will lead to avoidance or evasion in 2017-18. However, it plans to increase its compliance activity in future, if the thresholds and rates between Scotland and the rest of the UK diverge more substantially (paragraphs 1.5 to 1.9 and paragraph 3.27).

11 The timing of the Scottish Government's budget creates an administrative challenge for HMRC. Income tax rates and thresholds are announced in the annual Scottish budget, which is usually in the autumn before the tax year. However, the budget is not ratified until a later parliamentary vote, which means tax rates and thresholds are finalised near to the start of the new tax year. In 2016-17, this timetable created a very narrow time frame for HMRC to apply annual tax codes specific to Scottish taxpayers. This led to some Scottish taxpayers receiving two different notifications of tax codes in March 2017 (paragraphs 1.10 to 1.12).

12 The administration costs incurred by HMRC in 2016-17 were £6.3 million.

The total cost of administering the Scottish rate was £17.4 million to March 2017. HMRC expects to spend £26.8 million in total by 2019-20. As in previous years, the majority of the spending has been on IT costs, such as the cost of changing systems to account for the Scottish rate. We have concluded the amount repaid by the Scottish Government for the year ended 31 March 2017 is fairly stated (paragraphs 4.2 to 4.10).

Income tax collected from Scottish taxpayers

13 HMRC estimates it will collect £4.6 billion attributable to the Scottish rate of income tax for 2016-17.

Its estimate in 2016-17 was based on a sample of taxpayer information which was used to calculate the Scottish share of the whole-of-the-UK total. In future years, HMRC's annual estimate of Scottish income tax would benefit from the greater use of taxpayer data from its own systems, as this would allow for greater estimation accuracy. While there are aspects of the methodology that could be enhanced, we have concluded that the estimate of income tax attributable to the Scottish rate resolution for 2016-17 is fairly stated. Due largely to the self-assessment deadline in January 2018, the actual amount collected from Scottish taxpayers for 2016-17 will not be known until it is published in HMRC's annual report and accounts – planned for July 2018 (paragraphs 2.6 to 2.12).

14 The actual amount of income tax collected from Scottish taxpayers for 2016-17 will not affect Scottish Government funding.

The Scottish Government's block grant for 2016-17 was initially reduced by £4.9 billion, reflecting the Office for Budget Responsibility's autumn 2015 forecast of the income tax revenue foregone by the UK Government. However, because tax rates between Scotland and the rest of the UK remained the same in 2016-17, the Scottish Government received the equivalent amount back from the UK Government. The final outturn for Scottish tax receipts collected in 2016-17 will not affect the block grant to Scotland (paragraphs 2.4 and 2.5).

15 From 2017-18, the actual tax collected from Scottish taxpayers will begin to impact Scottish Government funding.

The Scottish Government will receive £11.9 billion in 2017-18 based on its forecast Scottish income tax revenue. This includes additional net revenue of £107 million that will be generated largely as a result of the lower threshold for Scottish higher rate taxpayers. A final adjustment to the Scottish budget will be made once the actual receipts for 2017-18 are determined in June 2019. There will be no impact on the Scottish budget as a result of this until 2020-21. Some areas of the funding cycle are yet to be agreed between the Scottish and UK governments including: how estimates will be reconciled to forecasts; exactly when this will happen; and the process for resolving any disputes (paragraphs 2.13 to 2.20).

Challenges in collecting tax from Scottish taxpayers

16 The biggest challenge facing HMRC is maintaining accurate address records of Scottish taxpayers.

Accurate address records are essential in determining the correct income tax due to the Scottish Government. If HMRC fails to hold accurate, up-to-date address information, it could lead to an individual paying the incorrect amount of tax, and the wrong government receiving the revenue. The risk of individuals seeking to manipulate their residency status increases if the tax rates and thresholds in Scotland diverge from those in the rest of the UK (paragraph 3.2).

17 Neither taxpayers nor employers are legally required to tell HMRC of changes of address.

Around 80,000 people in the UK move into or out of Scotland each year. HMRC monitors how many Scottish taxpayer codes it applies and removes on a monthly basis, however, its records do not enable it to determine how many changes are as a result of changes of address. Therefore HMRC does not know how many of the cross-border moves are captured each year. HMRC has checked its records against other databases and plans to expand its checks in 2017-18. Should tax rates and thresholds continue to differ from April 2018, this type of assurance work will become increasingly important (paragraphs 3.10 to 3.19).

18 HMRC encourages taxpayers to tell it about changes of address, but does not know how successful its communications are.

HMRC includes relevant information in regular bulletins and other contacts with employers and accountants. Around a quarter of businesses are signed up for bulletins. It carried out an online marketing campaign in spring 2017 to promote using Personal Tax Accounts for changes of address. It also used social media to promote this message. It does not know how many people it has reached or what impact it has had on public readiness to update HMRC about changes of address (paragraphs 3.20 and 3.30 to 3.36).

19 HMRC needs to ensure people paying into pension schemes receive the right amount of tax relief.

Some taxpayers may initially receive the incorrect amount of relief at source if the basic rate of income tax diverges between Scotland and the UK, and the information held by the pension provider is not up-to-date. Both providers and HMRC are making significant changes to strengthen the alignment between their information systems. HMRC has created a single online route for pension providers to submit annual returns which will improve the consistency of data. However, this will only become mandatory from April 2019 (paragraphs 3.37 to 3.45).

Conclusion

20 The first year of revenue attributable to Scottish taxpayers was 2016-17, and HMRC estimated this to be £4.6 billion. This amount will increase substantially from 2017-18 as the Scottish Parliament now has power to set all tax rates and thresholds. From 2017-18, the actual tax collected by HMRC – forecast to be £11.9 billion – will begin to impact Scottish Government funding, and additional tax revenue will be collected as a result of the lower threshold for higher rate taxpayers in Scotland. The actual outturn will be reconciled to the forecast and any adjustment in funding will be made in the budget for 2020-21 at the earliest. With actual Scottish taxpayer data now becoming available, HMRC has the opportunity to set out how this can be used to enhance its estimates of how much tax is attributable to Scottish taxpayers each year.

21 Maintaining accurate address records remains the biggest risk facing HMRC. It relies on individual taxpayers across the UK telling it when they change address. HMRC has sought to increase taxpayers' awareness of the importance of providing HMRC with the correct address, although it does not know what success these interventions have had. The potential for avoidance or evasion will increase if rates and thresholds diverge more drastically between Scotland and the rest of the UK, and it will become even more important for HMRC to have accurate address data.

Part One

Administering the Scottish rate of income tax

Income tax

1.1 Income tax is the largest tax stream in the UK. It is charged on earnings from employment, self-employment, pension income, foreign income, taxable benefits, income from property, savings income and dividend income. In 2016-17, 30.1 million people in the UK were liable to pay £174 billion of income tax on £1,012 billion of income.⁴

1.2 HM Revenue & Customs (HMRC) collects income tax as part of the UK tax system. Most income tax (86%) is collected from Pay As You Earn (PAYE) on earned income from employees, but much also comes from self-employed people via self-assessment tax returns.

Income tax in Scotland

1.3 The Scotland Act 2012 introduced powers for the Scottish Parliament to apply a Scottish rate of income tax, effective from 6 April 2016, to the non-savings, non-dividend income of Scottish taxpayers.

1.4 For the 2016-17 tax year, the UK basic, higher and additional income tax rates paid by Scottish taxpayers were reduced by 10 percentage points. The Scottish Parliament used its powers to apply a Scottish rate of 10%; effectively matching the rest of the UK at 20%, 40% and 45%, respectively. The revenue generated from the 10% Scottish rate was paid over to the Scottish consolidated fund during the 2016-17 financial year, with a corresponding reduction in the block grant.

1.5 The Scotland Act 2016 introduced further Scottish income tax powers, effective from 6 April 2017 (**Figure 2** overleaf). Under the 2016 Act the Scottish Parliament has the power to set rates and thresholds on all non-savings, non dividend income.

⁴ £173.8 billion was reported in the HMRC Annual Report and Accounts for 2016-17 and includes revenue generated from taxation of all types of income. Other numbers come from Personal Incomes Statistics 2014-15.

Figure 2

Scottish Parliament income tax powers

The Scottish Parliament's powers over income tax have grown

	1998 to 2016	2016-17 tax year	April 2017 onwards
Legislation	Scotland Act 1998	Scotland Act 2012	Scotland Act 2016
Powers available to the Scottish Parliament	The Scottish Parliament had powers to vary the basic rate of income tax by three percentage points of the UK rate.	The Scottish Parliament could apply a Scottish rate to the UK rates (reduced by 10 percentage points) in Scotland.	The Scottish Parliament can set any rates and thresholds.
Use of powers	The Scottish Government did not use this power.	The Scottish Government set 10% rates to match the UK rates.	For 2017-18, the Scottish Government chose to change one threshold but not change rates.
Fiscal impact	Neutral	Neutral	The Scottish Government forecasted that its tax revenue will increase by £127 million in 2017-18 due to the different higher rate threshold in Scotland.

Source: National Audit Office

1.6 For the 2017-18 tax year, income tax policy in Scotland has diverged from the rest of the UK (**Figure 3**). The Scottish Government has maintained the higher rate threshold at £43,000, while the UK Government has increased the threshold to £45,000. The Scottish tax rates across all income tax bands remained the same as the rest of the UK. HMRC estimates 386,000 Scottish taxpayers will pay the higher rate of income tax in 2017-18.⁵ Taxpayers in the rest of the UK will pay the higher rate of tax on income over £45,000. A small number of Scottish taxpayers whose non-savings and non-dividend income is less than £43,000, but with savings and dividend income which takes their total income over £45,000, will only pay the higher rate of tax on income over £45,000. We estimate that around 40,000 people with income between £43,000 and £45,000 would pay tax at a lower rate were they not Scottish taxpayers.⁶

1.7 The Scottish Government forecasts that holding the higher rate threshold at £43,000 will raise £127 million. The maximum impact of taxing the higher earner at £43,000 rather than £45,000 will be £630 – for married taxpayers in Scotland who lose their entitlement to Marriage Allowance.^{7,8} For taxpayers earning £43,000 or more but not affected by the loss of Marriage Allowance, the maximum impact will be £400. We estimate that the average extra tax paid by affected taxpayers will be around £330.⁹

5 HMRC, *UK Income Tax Liabilities Statistics 2014-15 Survey of Personal Incomes, with projections to 2017-18*, May 2017.

6 National Audit Office estimate. See Appendix One for methodology.

7 The UK Government has retained the powers to affect the application of Marriage Allowance in Scotland.

8 This calculation assumes the taxpayer receives the full Personal Allowance.

9 Calculated by taking the Scottish Government forecast of revenue that will be raised and dividing by the maximum number of higher and additional rate taxpayers in Scotland.

Figure 3

Income taxes and thresholds in 2016-17 and 2017-18

Income tax was the same across the UK in 2016-17, but the higher rate threshold is different in Scotland in 2017-18

2016-17	2017-18	
UK	Scotland	Rest of the UK
Personal allowance: No tax paid on income up to £11,000	Personal allowance: No tax paid on income up to £11,500	Personal allowance: No tax paid on income up to £11,500
Basic rate: 20% tax on income between £11,001 and £43,000	Basic rate: 20% tax on income between £11,501 and £43,000	Basic rate: 20% tax on income between £11,501 and £45,000
Higher rate: 40% tax on income between £43,001 and £150,000	Higher rate: 40% tax on income between £43,001 and £150,000	Higher rate: 40% tax on income between £45,001 and £150,000
Additional rate: 45% tax on income over £150,000	Additional rate: 45% tax on income over £150,000	Additional rate: 45% tax on income over £150,000

Note

1 Scottish income tax rates and thresholds apply to non-savings, non-dividend income only.

Source: National Audit Office

1.8 The UK Government retains power over other aspects of income tax policy, including tax reliefs and allowances. For instance, the Scottish Parliament does not have the power to set the personal allowance, but could introduce a zero rate band to increase the threshold at which Scottish taxpayers begin to incur tax on their income. The UK Government also retains power over income tax policy in relation to income from savings and dividends, which account for 9.3% of UK tax liabilities.

1.9 People with income from savings and dividends are particularly affected by the change in 2017-18. The different Scottish higher rate threshold for 2017-18 means that some will have to calculate their income tax liability partly using Scottish rules and partly using UK rules.¹⁰ The Chartered Institute of Taxation and Association of Taxation Technicians told us that this increases the risk of errors in self-assessment income tax.

1.10 The rates and thresholds will be announced in the annual Scottish Government budget. For the 2018-19 tax year, this is expected to be in late 2017. The budget announcement is then approved by a parliamentary vote shortly before the start of the new tax year.

¹⁰ Scottish taxpayers with different income streams will pay the higher rate of tax on non-savings, non-dividend income above a threshold of £43,000. However, they will only begin to pay a higher rate of tax on savings and dividend income above a threshold of £45,000.

1.11 HMRC issues tax codes to Scottish taxpayers in advance of the following tax year, which begins in April. The later the budget is finalised, the greater the administrative impact for HMRC. HMRC and the Scottish Government have not agreed any minimum period between the finalisation of the Scottish budget and the start of the tax year. The 2017-18 annual coding exercise generally went smoothly in respect of Scottish taxpayers. However, HMRC identified an issue that could potentially affect taxpayers with investment income. It quarantined these taxpayers – 193,000 in total – until HMRC’s IT supplier implemented fixes to resolve the problem. The corrections were made in time for April 2017, so taxpayers had the correct tax code for the 2017-18 tax year.

1.12 HMRC has encountered one main issue as a result of the tight time frame presented by the uncertainty around tax rates and thresholds in Scotland in advance of each tax year. In February 2017, the Scottish Government confirmed, following the Scottish Parliament’s vote on its budget, that the higher rate threshold would be £43,000 – not £43,430 as it had previously announced in December 2016. A total of 21,356 Scottish taxpayers were affected by this change. These individuals received two tax code notifications in March 2017: the first containing information on the original threshold; and the second containing information on the final threshold. This may have caused confusion for recipients.

Devolution of tax and spending powers

1.13 The Scottish Government’s budget is determined through a combination of three main components: block grant funding; forecasts of revenue generated from devolved taxes; and the planned use of borrowing. The composition of the budget has evolved as more income tax powers have been devolved (**Figure 4**).

1.14 The Scottish Government now has fully devolved powers to set policy and collect revenues for Land and Buildings Transaction Tax (which replaced Stamp Duty in Scotland from April 2015) and Scottish Landfill Tax. Other tax powers will be devolved to the Scottish Parliament in future, including, for example, the power to tax passengers leaving Scottish airports from 2018-19. From 2019-20, HMRC will apportion part of the VAT revenue collected in the UK to the Scottish Government.

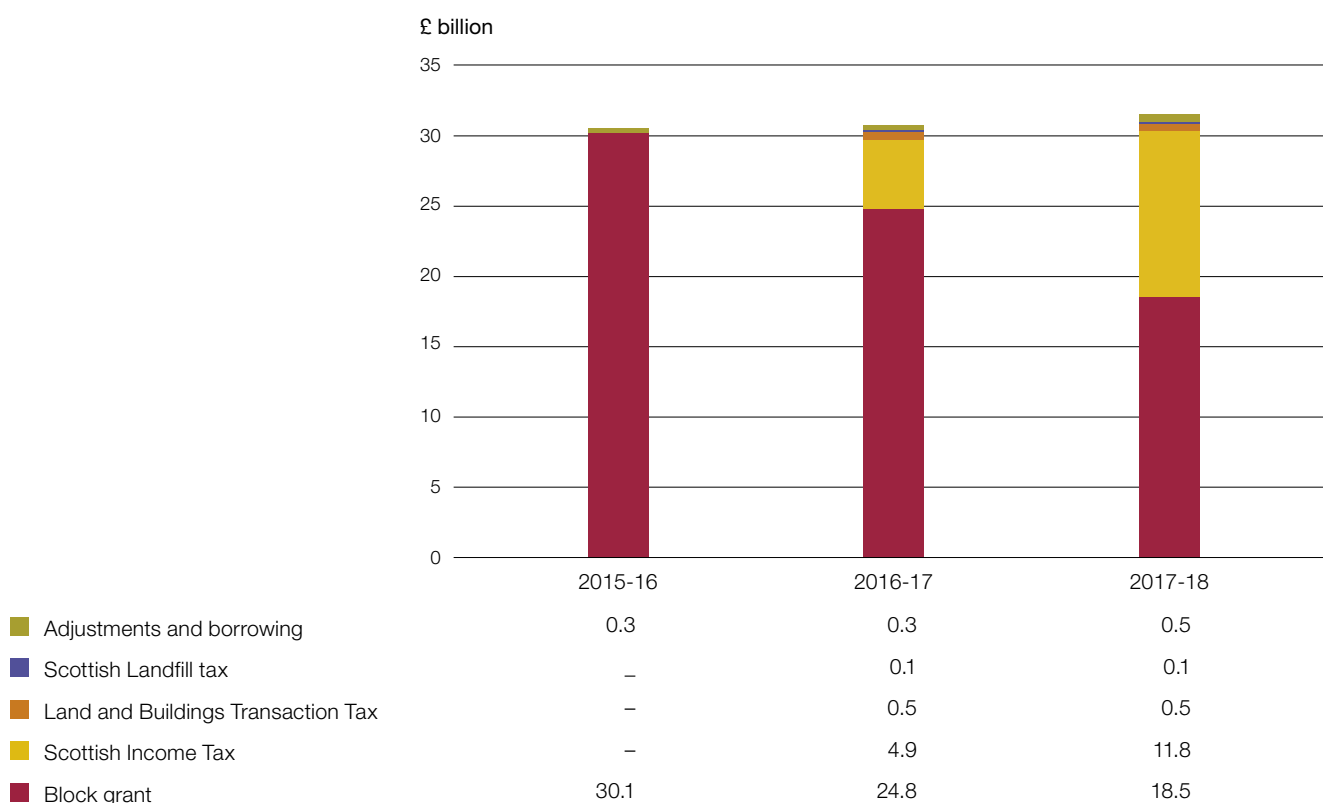
The block grant

1.15 The block grant is paid annually to the Scottish Government to fund devolved public services. The block grant is reduced by the ‘block grant adjustment’ to reflect the tax revenue that the UK Government has foregone as a result of devolution. The forecast of the revenue to be generated from the devolved taxes under the Scottish Government’s policies is then added back. The principles of how this process operates are set out in the fiscal framework agreed in February 2016 between the UK and Scottish governments.

Figure 4

Funding of the Scottish Government's budget

Scottish income tax revenue is an increasing proportion of the Scottish Government's budget funding



Source: National Audit Office analysis of Scottish Government document

The fiscal framework

1.16 A principle of the fiscal framework is that the Scottish Government's budget funding should reflect the income tax policy decisions that the Scottish Government makes.¹¹ The Scottish Government should benefit in full from policy decisions that increase revenues and bear the costs of policy decisions that reduce revenues.

1.17 The fiscal framework states that the Barnett Formula will continue to be used to calculate changes in the block grant funding for devolved public services.¹² However, an adjustment will be applied based on the estimated impact of the powers the Scottish Government has gained (**Figure 5** overleaf):

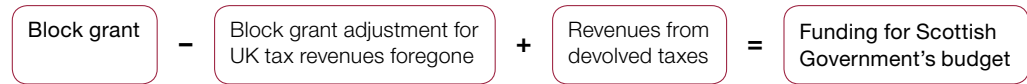
- for new spending powers, this will be an addition to the block grant; and
- for revenue raising powers, this will be a deduction from the block grant.

¹¹ *The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework*, February 2016.

¹² The block grant calculation is for spending on public services within the Departmental Expenditure Limit (DEL).

Figure 5

How funding for the Scottish Government's budget is determined



Source: National Audit Office

1.18 The Scottish Government's funding is determined approximately two years before actual tax receipts are known, so must be based on forecasts. The policy and funding cycle aims to adjust funding for the Scottish Government downwards if it received too much funding due to an overestimation, and upwards if it received too little funding due to an underestimation.

1.19 Once forecasts of the block grant adjustment and income tax revenue are determined, funding for that year is fixed. Any differences between forecasts and outturns for a specific tax year are dealt with later through a reconciliation process, which aims to ensure that the Scottish Government ultimately receives the correct amount of funding.

Other bodies involved

1.20 HM Treasury receives income tax collected by HMRC and gives this money to UK Government departments and – indirectly – the Scottish Government, via the Scotland Office. It also plays a role in the policy and funding cycle.

1.21 The Office for Budget Responsibility (OBR) is a public body sponsored by HM Treasury that produces forecasts, including forecasts of revenue from Scottish income tax. HMRC supports the OBR by providing the tax element of these forecasts, as it holds tax data. The OBR scrutinises and challenges HMRC's figures.

1.22 For 2017-18, the Scottish Government carried out its own forecasting. From 2018-19, the Scottish Fiscal Commission will do this. The Scottish Fiscal Commission became a non-ministerial department of the Scottish Government in April 2017. The Commission will use a range of data sources, including monthly Real-Time Information data on income tax receipts provided by HMRC. This will enable the Commission to analyse actual receipts during the tax year before the full outturn data become available after the year end.

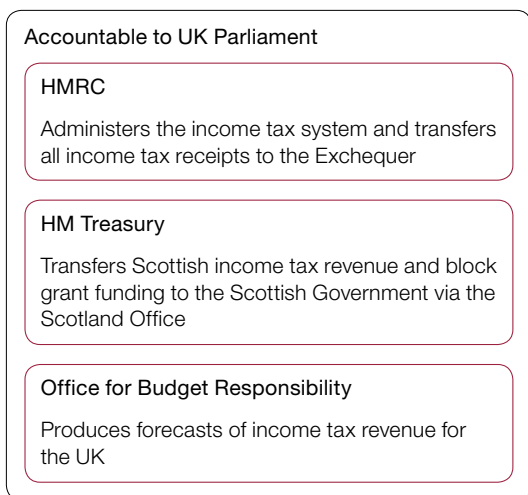
1.23 HMRC continues to administer the income tax system for the whole of the UK, and will collect tax attributable to Scottish taxpayers on the Scottish Government's behalf (**Figure 6**). The Scottish Government refunds the costs that HMRC incurs in running the Scottish rate of income tax.

Figure 6

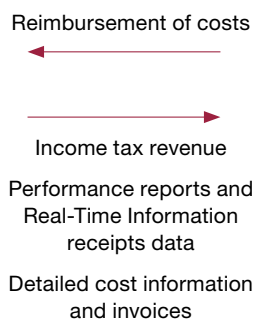
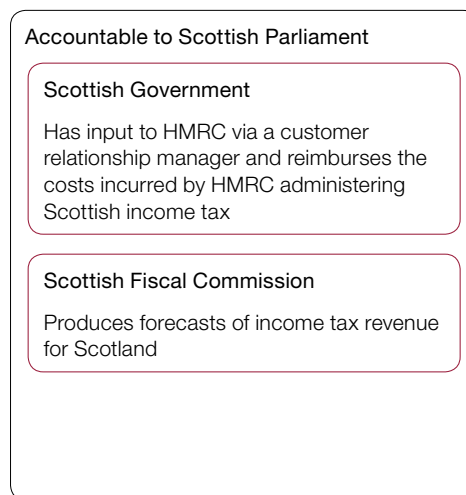
Accountability relationship between HMRC and the Scottish Government

HMRC collects income tax from Scottish taxpayers on behalf of the Scottish Government, with both bodies accountable to their respective parliaments

UK Parliament



Scottish Parliament



Note

1 Under the service level agreement between HMRC and the Scottish Government, the Scottish Government is required to reimburse the UK Government for “net additional costs wholly and necessarily incurred as a result of the administration of the Scottish income tax powers.”

Source: National Audit Office

Part Two

Income tax collected from Scottish taxpayers

2.1 The scope of this report includes HMRC's estimate of Scottish rate of income tax revenue collected in 2016-17. In future reports, we will review HMRC's calculation of the final outturn for Scottish income tax receipts.

2.2 Data available to HMRC in support of the 2016-17 income tax revenue collected under the Scottish rate is currently limited, and as a consequence we identified a number of limitations (see paragraph 2.12). However, we examined the methodology of the estimate within those limitations and found HMRC's approach to be reasonable. On the basis of our procedures, the estimate of income tax revenue collected for the Scottish Rate of Income Tax for 2016-17 is **fairly stated**.

2.3 This part of the report covers:

- our assessment of HMRC's calculation of revenue attributable to the Scottish rate of income tax in 2016-17;
- the features and limitations of HMRC's methodology, including the alternative approaches HMRC could take; and
- income tax attributable to Scottish taxpayers in 2017-18 and future years, and the impact of this estimate on the block grant from the UK Government to the Scottish Government.

The Scottish rate of income tax in 2016-17

2.4 For 2016-17, the block grant was reduced by the revenue foregone by the UK Government and the Scottish Government instead received the revenues generated from the 10% rate. As tax policies were the same across the UK, these adjustments were equal at £4.900 billion, based on the OBR's forecast produced in autumn 2015 (**Figure 7**).

Figure 7

How Scottish income tax affects funding for the Scottish Government's budget

The funding for the Scottish Government depends on forecasts of the block grant adjustment and Scottish income tax revenue

Block grant adjustment process	Block grant	-	Block grant adjustment for UK tax revenue foregone	+	Scottish income tax revenue	=	Funding for Scottish Government's budget
2016-17: Scottish rate of income tax	Block grant	-	£4.900 billion	+	£4.900 billion	=	Net effect on funding: nil
2017-18: Scottish income tax	Block grant	-	£11.750 billion	+	£11.857 billion	=	Net effect on funding: + £0.107 billion

Notes

- 1 £11.858 billion is the (rounded) figure included in the amended appendix of the Budget Bill 2017-18.
- 2 £0.107 billion is the net effect of funding. This comprises £0.127 billion increase in income tax, and a deduction for a £0.020 billion block grant adjustment. www.parliament.scot/S5_Finance/General%20Documents/Draft_Budget_2017-18_-_210217.pdf (para 170, page 13).

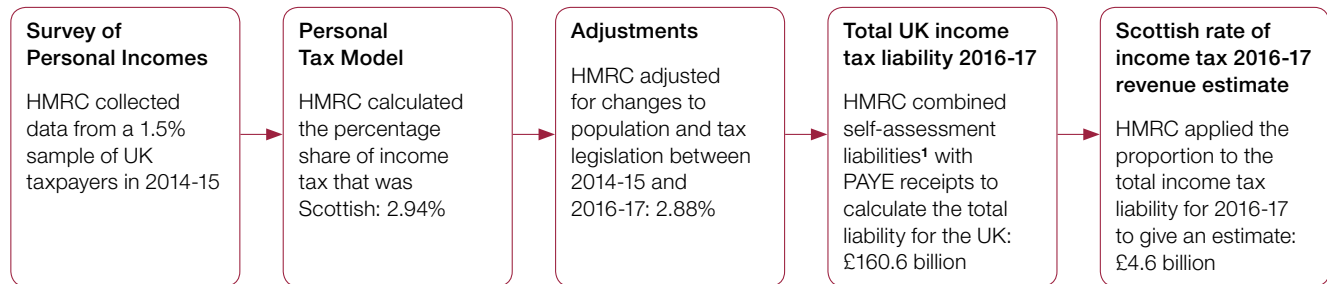
Source: National Audit Office

2.5 HMRC's latest estimate, published in its annual report and accounts, of the revenue collected during 2016-17 is £4.6 billion. The final outturn for tax receipts for the 2016-17 year will be calculated in June 2018. Because 2016-17 was a stand alone year before the introduction of the enhanced Scottish income tax powers in April 2017, there will be no reconciliation or adjustment for any difference between the original forecast and the final outturn, regardless of the actual tax HMRC collects.

HMRC's revenue estimate for 2016-17

2.6 HMRC calculated its estimate of revenue for the Scottish rate of income tax in 2016-17 using taxpayer data it extracted for its Survey of Personal Incomes. The data were analysed in a model replicating the UK income tax system known as the Personal Tax Model. This determined Scotland's share of the overall UK income tax liability. The Scottish share was then applied to the total UK tax liability, which is calculated by combining actual PAYE receipts from 2016-17 with an estimate of self-assessment liabilities for 2016-17 (**Figure 8** overleaf).

Figure 8
Method for calculating the 2016-17 revenue estimate



Note

1 Non-savings non-dividend income only.

Source: National Audit Office

2.7 HMRC estimates that it will collect £4.6 billion of income tax from Scottish taxpayers for 2016-17. The actual amount will be known once self-assessment data have been analysed, and it is published in HMRC's annual report and accounts for 2017-18. This is planned for July 2018. HMRC will explain any difference between the outturn and its estimate.

2.8 HMRC's annual Survey of Personal Incomes is a sample of around 1.5% of UK taxpayers' data from PAYE and self-assessment tax systems. It is used to produce national statistics and so is subject to time-consuming cleaning and checking. This process cannot begin until self-assessment submissions are received which is 10 months after the end of the tax year. Due to this timeline, HMRC used data from the 2014-15 tax year.

2.9 The Personal Tax Model projects the impacts of income tax policy changes implemented since 2014-15. It also models the outcome for income tax liabilities in 2016-17, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Scottish share.

2.10 Our review concluded that HMRC's approach is reasonable, however, there is scope for improving the accuracy of the calculation. As the method uses sample data which are grossed up to the full population in the Personal Tax Model, HMRC's calculation is simplified; only significant allowances and tax reliefs are included. This was necessary due to the lack of historical data available on income tax liabilities for the Scottish population.

2.11 HMRC has identified Scottish taxpayers in its records and flagged them by adding an 'S' prefix to their tax code. In future, HMRC should make use of the data it holds on Scottish taxpayers in its New PAYE System (NPS) tax system and explore possibilities to make greater use of data from its Real-Time Information (RTI) system to refine the method.

2.12 Our review of the model identified the following features and limitations:

- HMRC's use of sample data means it has to gross up from the sample to the full population. This means that its revenue estimate is subject to sampling uncertainty. It reports this uncertainty as 2.5% above or below its central estimate of revenue. However, HMRC reduces the uncertainty by oversampling additional rate taxpayers; just a few of these people moving into or out of Scotland could make a large difference to the revenue estimate.
- HMRC's calculation of the Scottish share is based on analysis of the total income tax liabilities – self-assessment and PAYE taxpayers – in Scotland and the rest of the UK using 2014-15 data modelled forwards to the current year. The method applies a single Scottish share to the total 2016-17 income tax liability. The estimate would be more accurate if the Scottish share of total self-assessment liabilities and total PAYE liabilities were calculated separately. Scotland has a lower proportion of self-employed people than the UK as a whole (12% compared to 15% in 2016-17).
- HMRC's data on PAYE receipts includes all income types; it does not exclude non-savings, non-dividend income.
- Based on historical data, HMRC assumes that receipts collected in the period May 2016 to April 2017 represent 99.5% of total PAYE liabilities for 2016-17. This does not consider the changing volume and value of underpayments and overpayments, which will be calculated after the year end.

Scottish income tax in 2017-18 and future years

2.13 From 2017-18 onwards, the Scottish Government will receive all income tax revenue generated from non-savings, non-dividend income under Scottish income tax policy. The block grant has been reduced by £11.750 billion, representing the revenues foregone by the UK Government. The Scottish Government will receive £11.857 billion¹³ based on its forecast of Scottish income tax receipts. The net result is an increase of £107 million.¹⁴ This is the additional revenue that will be generated largely as a result of the lower threshold for Scottish higher rate taxpayers (Figure 7).

2.14 The block grant adjustment is indexed using two different methods: comparable; and indexed per capita. Over the period up to and including 2021-22, if the two methods produce different results, then the indexed per capita method will be used. This is to ensure that Scotland's overall funding is unaffected if Scotland's population grows faster or slower than the population of the rest of the UK.

2.15 Once outturn data are available on the actual amount of tax collected, the forecasts of both Scottish income tax revenue and the block grant adjustment will be reconciled to the outturn data. Outturn data will be available 15 months after the end of the 2017-18 tax year, in June 2019. The outcome of the reconciliation will be factored into the Scottish budget in autumn 2019, affecting funding for the following financial year, 2020-21.¹⁵

2.16 The cycle of reconciling forecasts to outturn and adjusting for any gain or loss will therefore involve a minimum three-year lag before forecasting errors have a fiscal impact on the Scottish budget (**Figure 9** on pages 24 and 25).

2.17 The overall policy and funding cycle will take five years to play out, starting from a Scottish budget that sets rates and thresholds for the following year; a revenue estimate the year after; an outturn and reconciliation the following year; and finally, the adjustment for forecasting errors in the fifth and final year's budget. Therefore, 2020-21 is the first year that a reconciling adjustment could be made to funding.

¹³ £11.858 billion is the (rounded) figure included in the amended appendix of the Budget Bill 2017-18.

¹⁴ Comprising £127 million increase in income tax, and a deduction for a £20 million block grant adjustment. www.parliament.scot/S5_Finance/General%20Documents/Draft_Budget_2017-18_-_210217.pdf (para 170, page 13).

¹⁵ If the draft budget is introduced in the Scottish Parliament within two months of the reconciliation being completed, the outcome will be deferred for an additional financial year.

2.18 From 2020-21 onwards, the Scottish budget bears the risk of forecasting uncertainties. For example, if the forecast for Scottish income tax revenue matches the outturn, but the forecast block grant adjustment (for revenues foregone by the UK Government) significantly underestimates it, then a reconciling adjustment would be required in the form of a deduction from a subsequent Scottish budget.

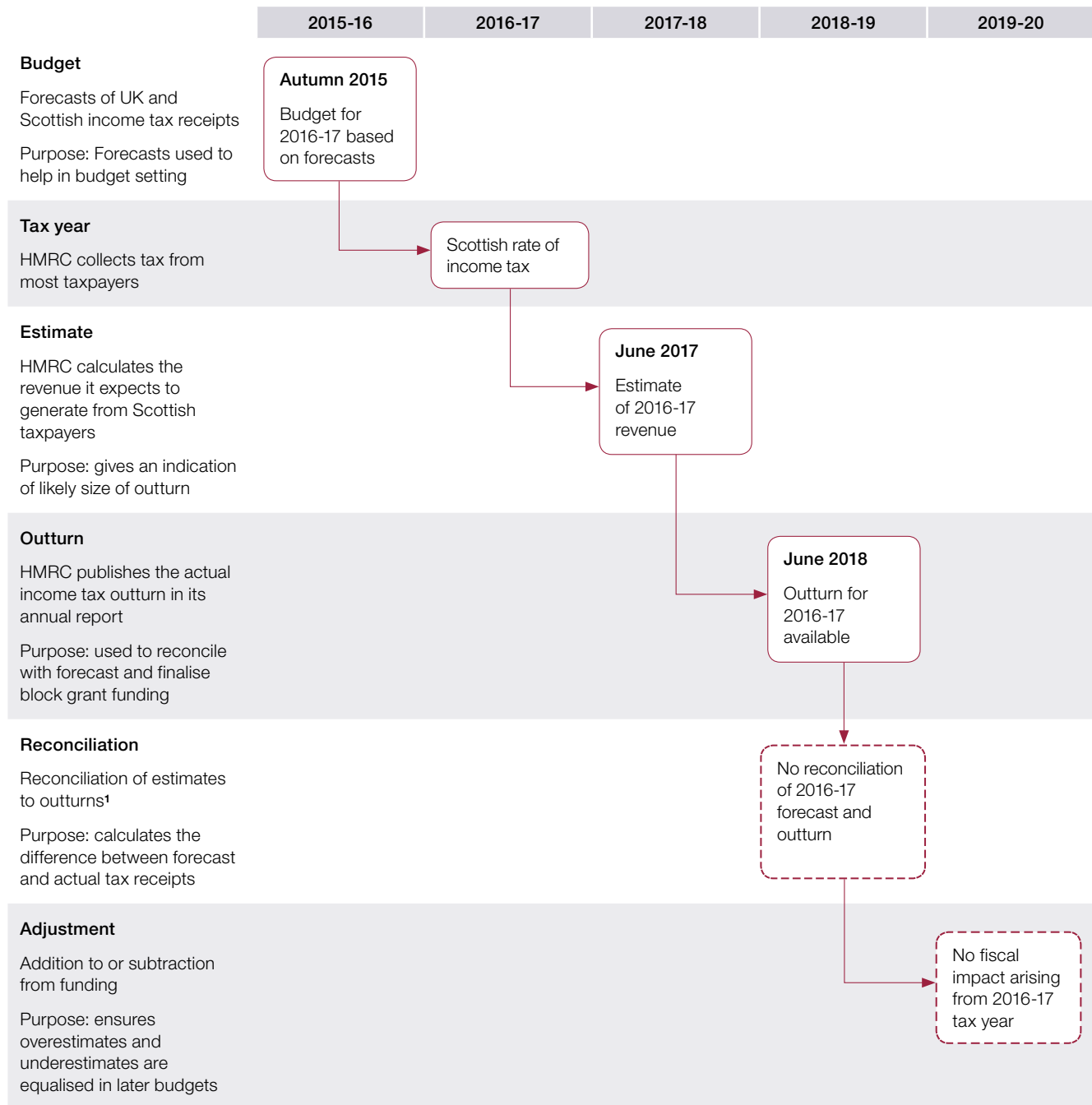
2.19 There are two principal controls in place to mitigate the risk of a large difference between forecast and actual receipts:

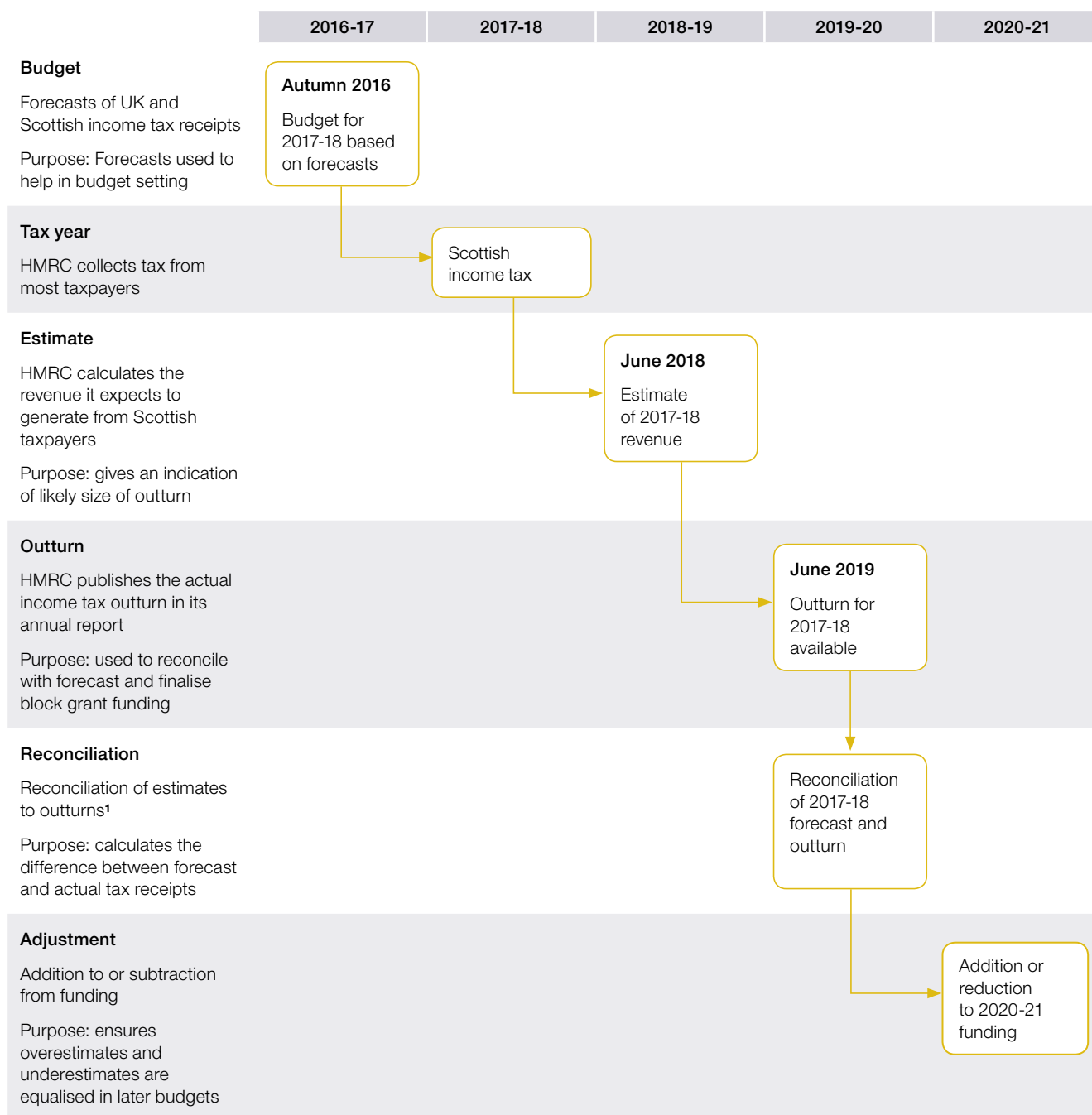
- **larger reserves** in the form of a higher cap on the amount the Scottish Government can draw from its reserves; and
- **greater borrowing powers** for the Scottish Government from HM Treasury's national loans fund.

2.20 Full details of how the reconciliation and adjustment process will operate are yet to be confirmed. Some areas remain unclear, such as: how estimates will be reconciled to outturns; the timeline for completion; and how any disputes will be resolved. It is not yet clear whether the reconciliation will be based on the outturn figure published in HMRC's audited accounts or based on unaudited data.

Figure 9
Funding timeline for Scottish income tax

In 2016-17, the Scottish rate of income tax will not affect funding for the Scottish Government's budget





Note

1 Reconciliation of estimates to outturns will apply to both Scottish income tax, which is added to the Scottish Government’s funding, and to the block grant adjustment, which is subtracted from the Scottish Government’s funding.

Part Three

Challenges in collecting tax from Scottish taxpayers

3.1 This part considers the administration of the Scottish rate of income tax and how well HMRC is managing risks. It covers:

- the procedures HMRC uses to identify and maintain an accurate record of Scottish taxpayers; and
- other activity undertaken by HMRC to understand and influence taxpayer attitudes and behaviour.

Taxpayer identification

3.2 The key challenge to HMRC's delivery of the Scottish rate of income tax is maintaining and updating its record of addresses in order to identify Scottish taxpayers. It is vital that HMRC ensures address details are correct so that the right amount of tax is collected from individuals and allocated to the appropriate government.

3.3 In our previous report, we outlined how HMRC had failed to identify 420,000 Scottish taxpayers in its initial taxpayer identification scan in December 2015.¹⁶ In June 2016, an interim solution was implemented to issue these individuals with coding notices. HMRC implemented a permanent IT solution in October 2016. This brought these taxpayers within HMRC's automated process for future years, and ensured that all in-year changes of Scottish taxpayer status were correctly reflected in their 2016-17 codes.

Defining a Scottish taxpayer

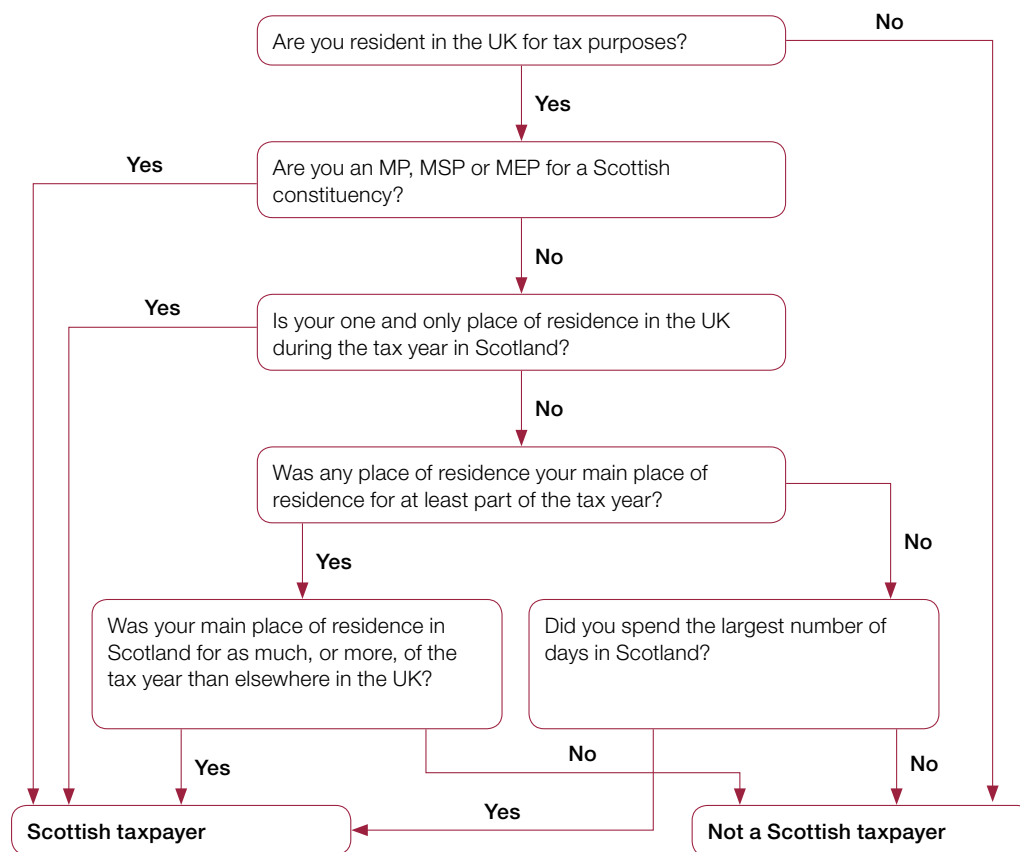
3.4 HMRC estimated that there were 2.6 million Scottish taxpayers in 2016-17. A 'Scottish taxpayer' is someone with a tax liability whose main place of residence in a given tax year is Scotland. Individuals are considered to be resident in Scotland if they spend most of that year (in most cases, 183 days or more) living in Scotland. HMRC flags Scottish taxpayers on its systems and assigns them tax codes beginning with the letter 'S'. Otherwise, its treatment of Scottish taxpayers is largely the same as its treatment of other UK taxpayers.

¹⁶ Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2015-16*, Session 2016-17, HC 871, National Audit Office, December 2016.

3.5 A person’s status as a Scottish taxpayer lasts for a whole financial year, even if they live in Scotland for only part of the year. When people move across the border, they may or may not become a Scottish taxpayer, depending when in the year they move. Moves after 5 October, six months through the tax year, cannot lead to changes in Scottish taxpayer status. Individuals are notified each time their status changes, though someone who moves frequently may only know their overall status near the end of a tax year. Residency rules are used to determine an individual’s residency status (**Figure 10**). This brings risks, including the risk of processing errors, and the risk that taxpayers will circumvent the rules to avoid or evade income tax.

Figure 10
HMRC’s rules for deciding whether someone is a Scottish taxpayer

Where someone moves into or out of Scotland during the year, HMRC uses residency rules to decide whether they are a Scottish taxpayer



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

3.6 HMRC's process for updating Scottish taxpayer status is automatic, but allows for some exceptions, notably for members of the Scottish, UK and European parliaments who represent Scottish constituencies.

3.7 HMRC is responsible for deciding whether to identify someone as a Scottish taxpayer. If a taxpayer disagrees with HMRC's decision, they can contact HMRC to provide their up-to-date address. They could escalate their disagreement to a first-tier tax tribunal. Nobody has done this so far.

3.8 We have assessed HMRC's residency rules and procedures to find out whether it is accurately classifying UK taxpayers as Scottish. We found the process was operating as designed. HMRC does not routinely check whether the number of days reported by taxpayers is accurate. HMRC does not consider that the current difference between UK Government and Scottish Government tax policies provides sufficient incentive for taxpayers to manipulate their residency status.

Updating address information

3.9 In the past, a person's location within the UK did not affect their tax liability, so HMRC did not need to set itself high standards for the accuracy of its address records. The potential for divergent tax rates in the UK means the accuracy of addresses is now more important to the UK tax system. HMRC's ambition is to improve the quality of its address data. By May 2017, HMRC had identified and corrected 55,000 instances of missing or partial Scottish postcodes in its data, enabling taxpayers living at these addresses to be identified as Scottish.

3.10 In 2015, HMRC tested its address records against other databases. These included the electoral roll and Royal Mail's postal address file. HMRC recognises that both sources could be wrong if neither it nor an employer holds the correct address. There is no independent record of the Scottish population for HMRC to compare its data with. HMRC told us it plans to repeat its checks again in 2017.

3.11 HMRC does not routinely carry out checks to ensure that taxpayers' contact details remain accurate but it has many sources of information on changes of address, including:

- taxpayers getting in touch directly to report a change of address;
- taxpayers noting a change of address on their self-assessment tax return;
- information from third parties, including pension scheme providers and the Department for Work & Pensions; and
- employers submitting employee addresses as part of Full Payment Submissions.

When HMRC becomes aware of a change of address into or out of Scotland, its systems automatically update the person's tax code to record them as either a Scottish taxpayer or a rest of UK taxpayer. HMRC updates its systems quarterly, based on data from Royal Mail, to reflect new and changed postcodes.

3.12 Taxpayers are not legally required to tell HMRC of a change of address, but HMRC encourages people to inform it when they move. This is the key message in its communications about Scottish income tax (paragraphs 3.30 to 3.36). People can update their details online via their Personal Tax Account, or phone or write to HMRC to report a change in circumstances. HMRC aims to reduce expensive manual processing of changes of address and move towards more taxpayer self-service.

3.13 Employers are not required to routinely send HMRC the details of employees who change address, and employers cannot notify HMRC of new addresses on behalf of their employees. Employers have to send a Full Payment Submission to HMRC whenever they process payments to employees – usually monthly. HMRC’s payroll guidance says employers should “enter their address if they’re a new employee, you don’t know their National Insurance number or the employee’s address has changed”.

3.14 HMRC has rules for deciding which address to hold for a taxpayer, if it has conflicting information from them and their employer. The addresses HMRC receives from employers via Full Payment Submissions must pass tests to be actioned, including:

- the new address appears in the three most recent returns;
- the new address is complete, with matching address and postcode; and
- HMRC has not held the address for this taxpayer in the past.

3.15 In February and March 2017, HMRC made 170,000 address changes based on these returns. However, it did not action most of the addresses provided in returns, because they failed one of its tests. HMRC does not know how many of the 170,000 address changes represented a move into or out of Scotland.

Communicating changes of circumstances to HMRC

3.16 In 2014, research by Ipsos MORI for HMRC found a generally “low level of awareness of obligations to inform HMRC about changes in circumstances and a reliance on employers or accountants to do this.”¹⁷ It found that PAYE taxpayers tended to feel that the responsibility for keeping HMRC informed lay with their employer rather than themselves. Among employers, it found a lack of clarity about whether responsibility to tell HMRC lay with them or their employees.

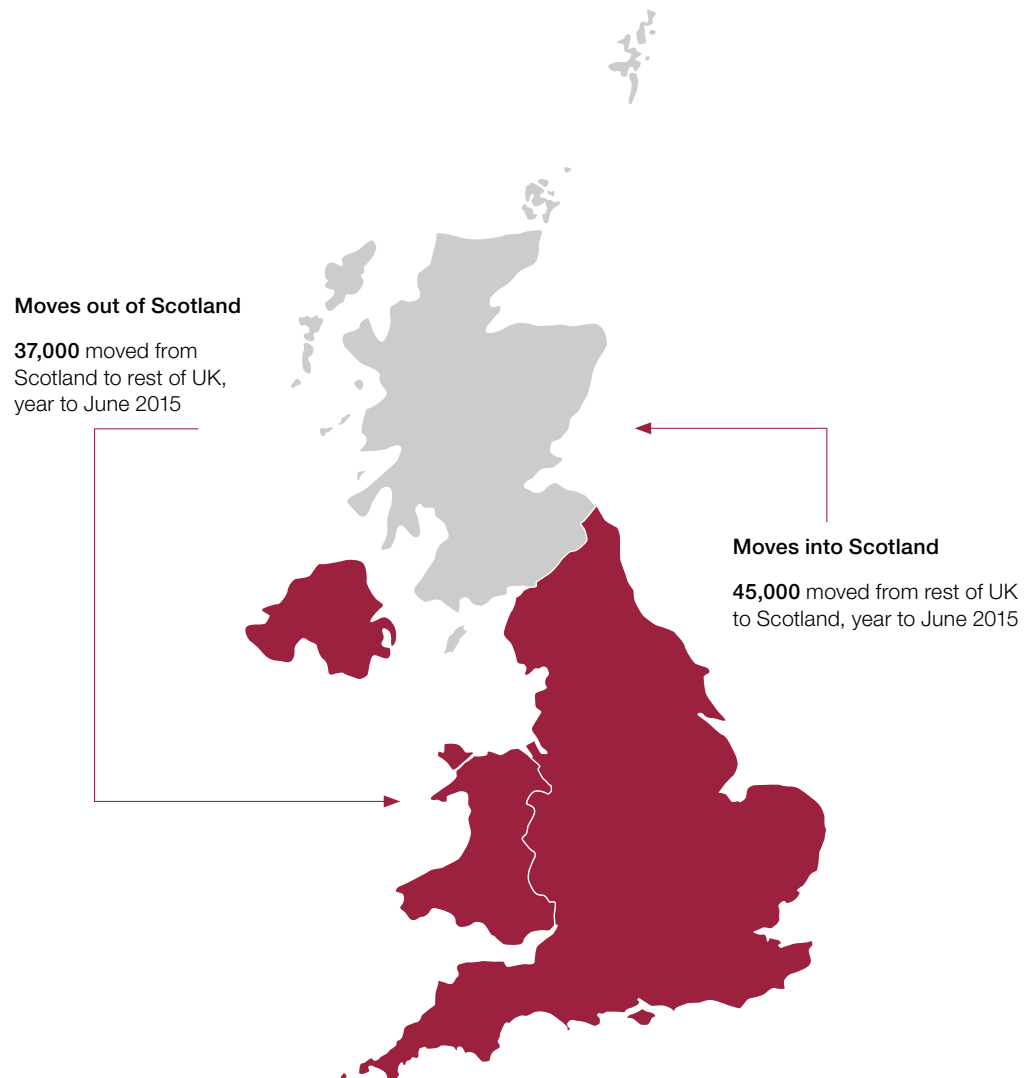
3.17 HMRC has not carried out subsequent research on any changes in public attitudes towards informing it of changes of address. Stakeholder groups told us they believed that public awareness was low.

3.18 Changes of address are common, with millions moving within the UK each year. But moves across the Scottish border are less common, with around 80,000 people moving per year. Between July 2015 and June 2016, an estimated 2.85 million people moved between local authorities in England and Wales. In the year to June 2015, 45,000 people moved from the rest of the UK to Scotland, and 37,000 people moved from Scotland to the rest of the UK (**Figure 11**).

Figure 11

Flows between Scotland and the rest of the UK

In the year to June 2015, around 80,000 people moved across the Scottish border



Source: National Audit Office analysis of Office for National Statistics data

3.19 HMRC is currently unable to confirm how many address changes it processes each year. HMRC monitors how many Scottish taxpayer codes it applies and removes each month. However, its records do not enable it to determine how many changes are as a result of changes of address that occurred within a set period of time. It has no plans to change its system to allow it to extract this information. HMRC does know that, in the quarter April to June 2017, it processed 110,415 changes to addresses via Personal Tax Accounts, the equivalent of approximately 442,000 in a year.

Personal Tax Accounts

3.20 In 2019-20, HMRC plans to require all self-employed people and landlords with an annual turnover above £10,000 to submit quarterly income tax reports online. This will make it easier in some ways and more challenging in other ways for HMRC to maintain accurate address records:

- Addresses will become **less important** in this paperless system, so there is a risk that more people will not correct out-of-date addresses.
- However, the address held by HMRC will become **more visible** to people through the Personal Tax Account, unlike incorrectly addressed post, which taxpayers may not receive.

3.21 HMRC consider that Personal Tax Accounts will improve address records because they increase the regularity of people's contact with HMRC, and make it easy to update addresses. HMRC told us that, in June 2017, 10.9 million people had set up an account, of which 8% were in Scotland. Of people with accounts who changed their address using their account, 7% were Scottish.

Compliance risks

3.22 As we discussed in our previous report, HMRC aims to tackle non-compliance by taxpayers in three ways: to promote compliance with tax law, such as by making it easier for taxpayers to pay tax; to prevent non-compliance before it occurs; and to respond robustly to recover unpaid tax.¹⁸ Compliance activities in relation to Scottish income tax are, broadly, either to confirm the individual's residency status or form part of HMRC's normal compliance procedures into the affairs of all taxpayers, including Scottish taxpayers. HMRC's compliance strategy identifies the risk that taxpayers change their behaviour in response to a higher or lower Scottish rate by:

- not updating their address;
- deliberately manipulating their address;
- setting up contrived employment structures; or
- switching their income to capital receipts, for example through incorporation of a business.

¹⁸ Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2015-16*, Session 2016-17, HC 871, National Audit Office, December 2016.

3.23 As tax rates and thresholds were the same across the UK in 2016-17, there was no risk of avoidance or evasion as a result of the Scottish rate of income tax, and HMRC does not expect any non-compliance.

3.24 HMRC does not expect compliance risks to materialise in 2017-18, because the difference between the higher rate threshold in Scotland and in the rest of the UK is small in 2017-18. It thinks the difference – a Scottish taxpayer paying a maximum extra £630 or £400 (see paragraph 1.7) – will have little behavioural impact. HMRC has decided not to adjust its risking rules to reflect the higher risk posed by Scottish higher rate taxpayers in 2017-18.

3.25 HMRC's main analysis of risks to tax – its strategic picture of risk – does not cover the Scottish rate of income tax. This is because these risks do not fulfil its criteria of representing either £250 million gross risk to revenue or a significant reputational, social or economic impact. However, it has adapted its standard risk model to cover Scottish-specific tax risks, and shared this with the Scottish Government. HMRC monitors cross-border migration trends to identify possible evidence of behavioural responses.

3.26 HMRC's expectations are in line with Office for Budget Responsibility (OBR) forecasts. The OBR forecast in March 2017 that the different higher rate threshold in Scotland in 2017-18 would have a relatively small behavioural effect. This is because of the relatively small tax rise for Scottish taxpayers. It expects that taxpayers in Scotland would have a lower incentive to earn and report additional taxable income. It found a negligible effect on the incentives for higher earners to incorporate their businesses rather than keep their status as employees or self-employed. It also found only a small effect due to Scottish taxpayers bringing their income forward into 2016-17 rather than paying more tax on it later. Finally, it considered the maximum individual tax gain too small to prompt many Scottish taxpayers to move house.

3.27 In 2016-17, HMRC did not spend any money on compliance work specifically relating to the Scottish rate of income tax. In 2015-16, it spent £30,000 on Scottish rate of income tax-specific compliance activity. A feature of this was analysing high-net-worth individuals in Scotland, and the potential for a change in behaviour if the income tax rate in Scotland diverges from the rest of the UK. It is possible that rates and thresholds may diverge more substantially from April 2018, and HMRC expects that some people would avoid or evade a larger difference. HMRC told us it would plan a proportionate increase in its compliance effort according to the size of future differences between Scotland and the rest of the UK.

Groups of taxpayers assessed as riskier than average

3.28 HMRC expects there to be a greater degree of risk attached to people with more than one address. It foresees the possibility that misrepresentation of place of residence could increase should UK and Scottish tax policy diverge significantly.

3.29 HMRC sees wealthy people as the riskiest group of taxpayers. It has rated the appetite of affluent people for engaging in non-compliance. As we reported last year, it has established a team in East Kilbride to deal with high-net-worth Scottish taxpayers, who are each allocated a customer relations manager.¹⁹ Overall it considers that the risk for self-assessment income taxpayers is higher than that for PAYE income taxpayers, because self-assessment taxpayers are more able to affect how much tax they pay.

Communications

3.30 HMRC has several audiences for its messages about the Scottish rate of income tax, including taxpayers, employers, pension providers, and accountants. It has a communication strategy for the Scottish rate of income tax, which it last updated in April 2013. HMRC also has an engagement strategy, from May 2016, for its work on further Scottish income tax powers. Its key message has remained that it is important to keep address details up-to-date.

3.31 In our previous report, we said that HMRC's key message would only become established taxpayer behaviour with a sustained communication campaign.²⁰ However, we reported that HMRC forecast no further spending on Scottish rate of income tax-specific communications outside of its own usual communication channels.

3.32 HMRC knows the reach it has achieved with some of its communications. There are around 650,000 subscribers to notifications of its employer bulletins, or around one quarter of the 2.55 million businesses registered for PAYE or VAT in the UK. For example, in April 2017, HMRC's magazine for employers stated: "if your employees have moved home recently, please ask them to tell us their new address." This information is also available online to non-subscribers.

3.33 HMRC has carried out some research on its communications for the Scottish rate of income tax project, but it has not evaluated their impact. This means it does not know if its actions have led to any changes in how likely people are to update their address details after a move. HMRC acknowledges that it has room to improve its evidence base on the impact of its communications.

¹⁹ HMRC defines high-net-worth individuals as having a net wealth of £10 million or over.

²⁰ Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2015-16*, Session 2016-17, HC 871, National Audit Office, December 2016.

3.34 HMRC's communications activities – some of which were one-off and others of which have been repeated – comprise:

- a Personal Tax Account campaign in spring 2017;
- an employer bulletin and an agent bulletin – a standing item in every issue, issued six times per year;
- direct communications with employers – emails to payroll managers in public bodies and large businesses based in Scotland, employer letter and employer paper pack;
- customer relationship managers;
- four gov.uk pages;
- occasional use of social media; and
- a standing item at employer forums and vulnerable groups forums.

3.35 HMRC carried out a UK-wide online marketing campaign in spring 2017, at an estimated cost of £793,000. This promoted the message that people should inform it if they move house. It was part of a campaign to promote Personal Tax Accounts rather than a dedicated Scottish rate campaign, and did not mention the risks posed to income tax specifically. HMRC is currently evaluating the campaign.

3.36 HMRC directs taxpayers to relevant gov.uk web pages rather than encouraging phone calls. Accordingly, it has received many more hits on gov.uk than phone calls. In 2016-17, people made 1,772 phone calls to HMRC about the Scottish rate of income tax. This means they rang HMRC's personal tax helpline and selected the Scottish rate of income tax option. There were 178,379 hits on four gov.uk pages of information and guidance about the Scottish rate of income tax.

Tax relief on personal pension contributions

3.37 The UK Government provides incentives for people to save into a pension through the tax system. One way it achieves this is through a tax relief on contributions to personal pensions, called 'relief at source'. HMRC gives pension providers an amount equal to the 20% basic rate, meaning that people do not pay tax on these pension contributions. If basic rates diverge, Scottish taxpayers will be due different basic rates of relief on their pension contributions, compared with taxpayers elsewhere in the UK.

3.38 HMRC receives around 900 returns a year from around 700 providers covering around 19 million scheme members (**Figure 12**). Of these around 414,000 are Scottish memberships.

Figure 12

Relief at source in summary

Pension scheme providers claimed tax relief from HMRC on behalf of 19.2 million members in 2016-17

Providers providing schemes ¹	684
Schemes	919
Members of schemes	19.2 million
Income tax relief on registered pension schemes in 2016-17 ²	£23.9 billion
Average tax relief per member	£1,245

Notes

1 However, between 2014 and 2016, a total of 799 providers sent HMRC annual returns.

2 Forecast.

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

Planned changes to relief at source

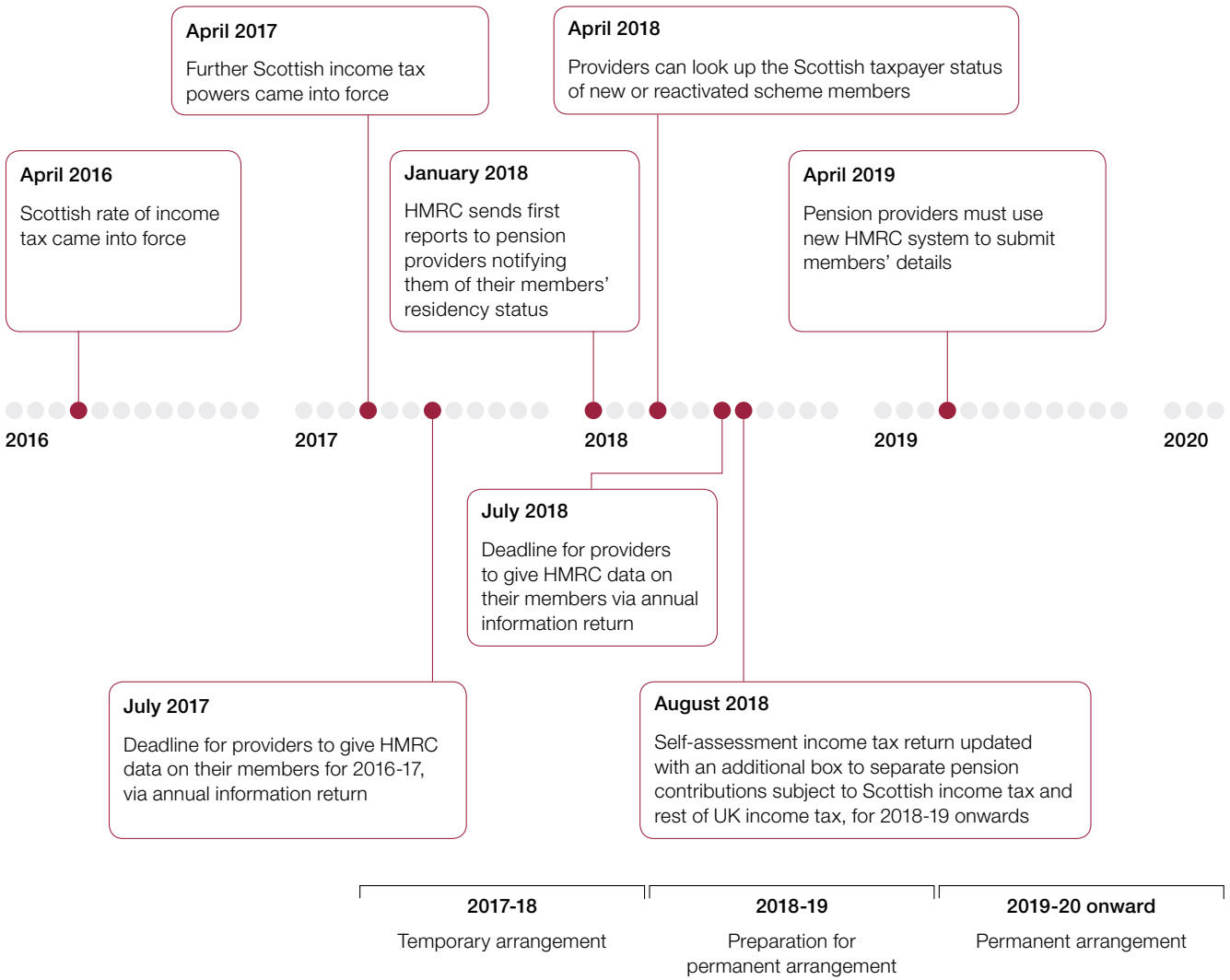
3.39 The relief at source project requires HMRC and pension providers to make changes to their IT systems. To administer relief at source, HMRC requires all providers to send it an annual report in a set format, listing all member contributions in the previous tax year. The annual returns, known as 'COM100s', currently come in different forms including paper, CD ROM, USB, and emailed spreadsheets. In future, providers will only have one way to submit returns; HMRC's online Strategic Data Exchange Service (**Figure 13** overleaf). It will be possible for providers to submit returns this way from April 2018, and will be compulsory from April 2019.

3.40 HMRC plans that the new system will be in place in April 2019. Ministers agreed to a two-year transitional period (2016-17 and 2017-18) to allow the pension industry to prepare. Basic rates have been the same across the UK in 2016-17 and 2017-18, so this delay does not leave any taxpayers better or worse off. HMRC has not yet introduced automatic processing of the residency status of scheme members. Until the new system is in place, HMRC is responsible for calculating any shortfall or excess payment given by pension providers to Scottish taxpayers.

Figure 13

Timeline for changes to relief at source

HMRC plans to implement its solution to tax relief for pension contributions by Scottish taxpayers in April 2018, and the new system will be compulsory from April 2019



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

3.41 At present, pension providers do not necessarily know whether their members are Scottish taxpayers. HMRC plans to address this by introducing a secure look-up service from January 2018. This will allow providers to look up new members in batches to find out if they have Scottish taxpayer status. It will take the form of a website with secure accounts for accredited pension providers.

3.42 The timing of the returns process will also change. Since July 2017, providers have to submit members' details to HMRC in July each year. HMRC will upload members' status – whether they are a Scottish taxpayer or not – onto the new system in January each year.

Challenges in implementing changes to relief at source

3.43 HMRC considers data matching the number one risk for the project. HMRC will have to match providers' records of their members to its own taxpayer records, based on National Insurance numbers. These may be missing or inaccurate. HMRC analysed a sample of individual scheme member records and found that the average percentage of blank National Insurance numbers per scheme was 0.004%. Partly as a result, it downgraded this risk from red to amber. HMRC has also carried out work to improve data quality, including data cleansing and introducing data validation checks into IT systems.

3.44 Another risk the project faces is correctly identifying all pension providers, so that HMRC can communicate with the whole sector. There is no definitive list of pension providers so HMRC cannot be sure that its messages have reached everyone it needs to. HMRC has held forums and published information on gov.uk among other communications activities to publicise the coming changes.

3.45 HMRC's planned process presents some risks. HMRC has recognised it will need to communicate clearly with the individuals affected.

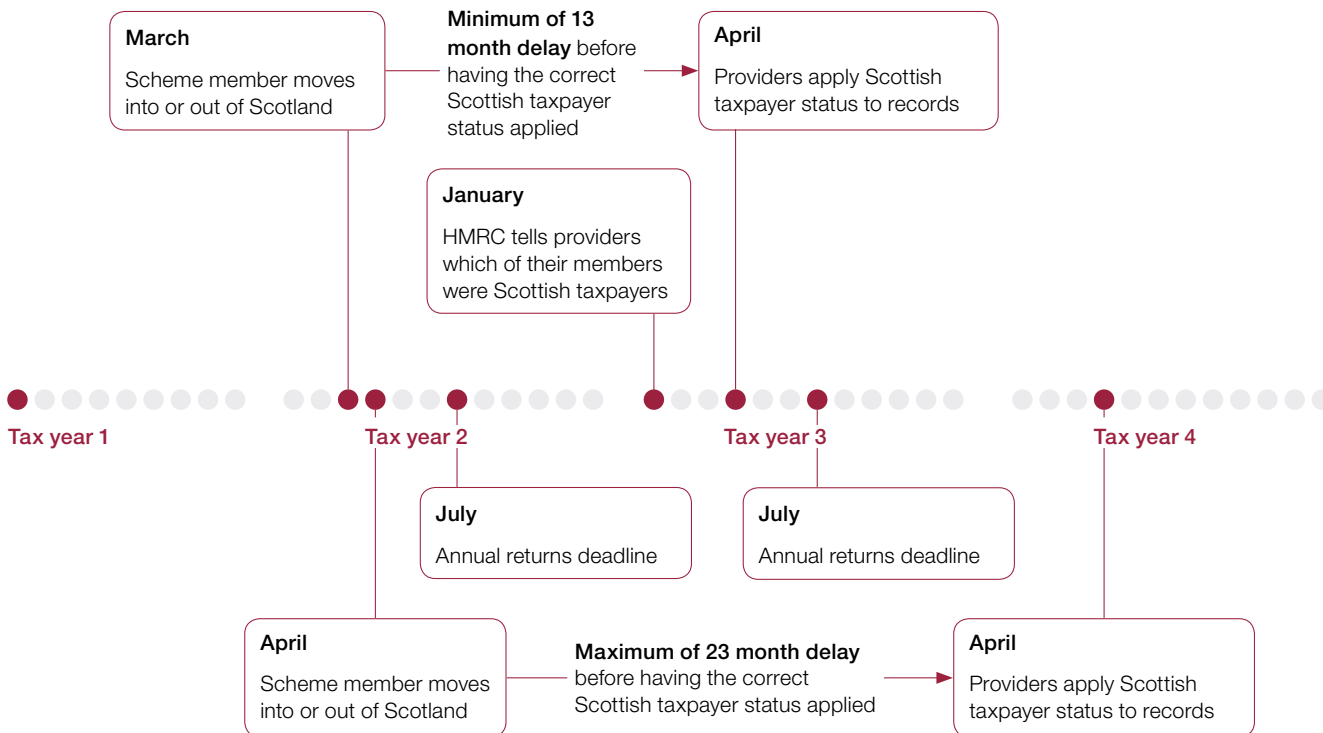
- a** HMRC's process operates in arrears, so it takes between 13 and 23 months for providers to apply Scottish taxpayer status to their records (**Figure 14**). HMRC sets a single status for the whole financial year, even when people move across the border during the year. This design means some people's pension relief and tax code will not have the same Scottish taxpayer status, bringing a risk of confusion.
- b** HMRC's process means that some people who move across the Scottish border will initially receive the wrong amount of relief because their former taxpayer status has been applied. HMRC has plans to correct this. For people who overpay, HMRC will send a P800 notice and adjust their tax code for the next year. For people who underpay, HMRC will send refunds directly. Individuals who receive a refund will have to pay this into their pension themselves. It estimates that there will be 15,500 of these.²¹
- c** There is also a risk of confusion and incorrect relief payments for some people with more than one policy. Someone with two policies, for example, could receive two different rates of relief for the same year. This is because, when someone sets up a new policy, their pension provider will be able to use HMRC's look-up service to check their status and ensure it is accurate from the beginning, whereas it takes longer for HMRC to update providers with the status of existing policyholders. It will correct underpayments and overpayments in the same way as for (b) above.

²¹ This is HMRC's estimate of the number of people who make cross-border moves in a year in which they receive relief at source.

Figure 14

Relief at source process from April 2019

The planned timetable operates in arrears, so it will take between 13 and 23 months for providers to apply Scottish taxpayer status to their records



Note

1 Providers will be able to use a look-up service during the year.

Source: National Audit Office

Part Four

Costs

4.1 This part considers the administrative costs of the Scottish rate of income tax, and whether these costs are accurately estimated and reasonable.

Costs incurred in 2016-17

4.2 We have previously reported that the Scottish Government reimbursed £1.7 million to HMRC for the cost of implementing the Scottish rate of income tax in 2014-15, and £8.4 million in 2015-16 (**Figure 15**). In 2016-17, £6.3 million was spent on the three Scottish rate of income tax and related projects.²² The cost to date is £17.4 million.²³ HMRC sends invoices directly to the Scottish Government each quarter. It incurred costs of £148,259 which it did not charge to the Scottish Government in 2016-17. This was the cost of changing its systems so that Scottish addresses no longer needed to be recorded exactly as in the Royal Mail Postcode Address File for the people living at the addresses to be flagged as Scottish taxpayers.

4.3 Of all costs in 2016-17, 72% were IT costs. IT costs included, for example, the cost of making changes to financial accounting systems to account for the Scottish rates, and the cost of changes to automated letters, to refer to the Scottish rates. The remainder were staff costs (24%) and other spending, including travel and postage (4%).

4.4 We examined HMRC's method for estimating the costs of collecting and administering the Scottish rate of income tax for the year to ensure this was reasonable. Based on our procedures, the amount repaid by the Scottish Government for the year ended 31 March 2017 is **fairly stated**.

Robust performance and cost data

4.5 HM Treasury guidance requires departments to report accurate and meaningful financial information about performance. It is also important that the Scottish Government receives data that allows it to hold HMRC to account for its performance in administering the Scottish rate of income tax. Early in 2016-17, the Scottish Government did not think it had received enough information on costs from HMRC. HMRC addressed this concern by providing more detail, including monthly cost profiles.

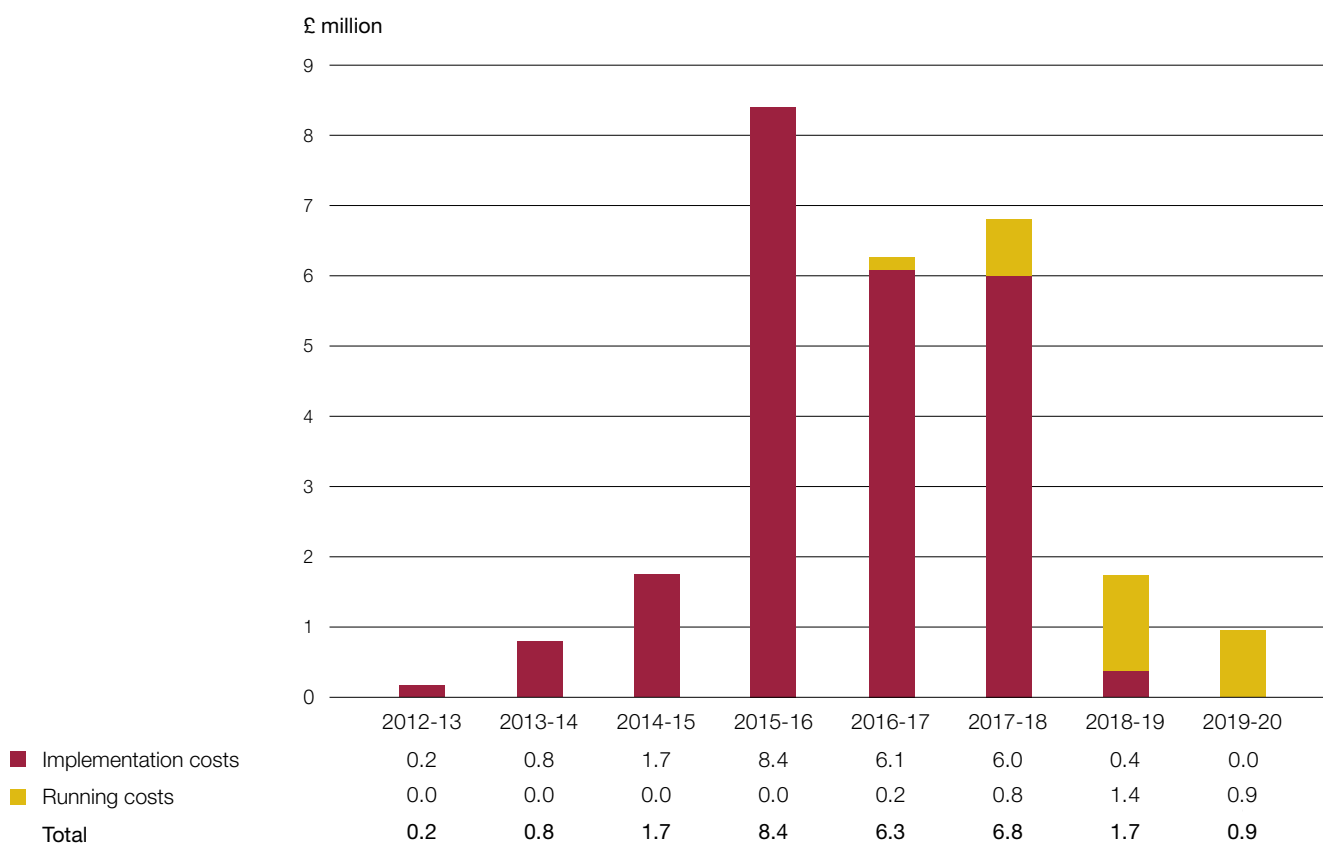
²² Due to rounding, this revised figure is higher than the £6.2 million published in HMRC's annual report and accounts 2016-17, due to late receipt of an invoice for £33,000.

²³ Includes costs incurred pre-April 2014 of £1.0 million.

Figure 15

Actual and forecast spending, 2012-13 to 2019-20

Spending is moving from implementation costs to business-as-usual running costs

**Note**

- 1 Costs are for the Scottish rate of income tax project and the further Scottish income tax powers and relief at source projects.
- 2 Figures are actual up to and including 2016-17, and forecasts from 2017-18 onward.
- 3 Figures may not sum due to rounding.

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

4.6 Every year, the service level agreement between HMRC and the Scottish Government requires HMRC to provide performance data to the Scottish Government. The Scottish Government was originally supposed to receive the first quarterly report in October 2016, but received its first report in July 2017. It contained information on changes in customer contacts and complaints. It did not contain information on changes in Scottish taxpayer status because of HMRC's concerns about the accuracy of these data.

4.7 HMRC agreed to provide the following to the Scottish Government:

- an assessment of risk and planned approach to compliance activity;
- details and outcomes of compliance activities undertaken;
- data on address record checks and in-year changes to Scottish taxpayer status;
- Scottish income tax receipts and liabilities;
- customer service performance; and
- administrative costs.

Estimated total cost of implementing the Scottish rate of income tax

4.8 HMRC forecasts to spend £26.8 million in total on implementing the Scottish rate of income tax and two associated projects: further Scottish income tax powers; and relief at source. These run from 2012-13 to 2018-19. Most of the remaining expenditure will be on implementing the relief at source project (paragraphs 3.39 to 3.45).

4.9 The estimated lifetime costs of the projects have fallen over time from the maximum of £35 million initially expected.²⁴ HMRC explained that this was due to increasing precision about costs as work progressed, rather than the work reducing in scope or HMRC cutting any of its plans.

Factors affecting the administrative cost

4.10 The cost of administering the Scottish rate of income tax is higher if the Scottish rate diverges from the UK rate. In October 2015, HMRC estimated that the running costs from April 2016 would be between £2 million and £2.5 million if the Scottish rates matched the rest of the UK, and between £5.5 million and £6 million if they were different. The cost will increase if:

- the Scottish Government changes the band structure, such as adding or removing bands;
- a large number of Scottish taxpayers are affected by a change;
- changes result in more customer contacts; or
- changes come late in the year.

24 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.

Appendix One

Our audit approach

1 We reached our findings following our analysis of evidence collected between May and September 2017. We outline our main methods below.

Document review

2 We reviewed published and unpublished HMRC documents about the Scottish rate of income tax. We also reviewed information published by the Office for Budget Responsibility, Scottish Government, Office for National Statistics and HM Treasury, and reports on research carried out on HMRC's behalf by Ipsos MORI.

Data analysis and model review

3 In Part One, we reviewed HMRC's UK Income Tax Liabilities Statistics (ITLS), which estimates the number of Scottish higher and additional tax payers in 2017-18. Income Tax Liabilities Statistics is a National Statistics publication by HMRC. This uses data from the Survey of Personal Incomes from 2014-15 – the latest available data – and projects forwards to 2017-18. The data is projected using economic assumptions consistent with the Office for Budget Responsibility's (OBR) March 2017 Economic and fiscal outlook.

4 The £43,000 higher rate threshold taking effect from April 2017 only applies to non-savings and non-dividend income. Taxpayers in the rest of the UK will pay the higher rate of tax on income over £45,000. A small number of Scottish taxpayers whose non-savings and non-dividend income is less than £43,000, but with savings and dividend income which takes their total income over £45,000, will only pay the higher rate of tax on income over £45,000. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/616452/Income_Tax_Liabilities_Statistics_May_2017.pdf (Table 2.2, page 31).

5 In Part One, we used HMRC's statistical tables of income by percentiles across the UK (<https://www.gov.uk/government/statistics/percentile-points-from-1-to-99-for-total-income-before-and-after-tax>) to estimate the number of taxpayers in Scotland who had income between £43,000 and £45,000 and would pay tax at a higher rate than others in the UK. We then applied this to the estimated Scottish taxpayer population of 2.6 million. This calculation assumes that income distribution is the same across Scotland and the rest of the UK. It also assumes a linear distribution between income percentile points.

6 Part Two describes HMRC's methodology in estimating the revenue attributable to the Scottish rate of income tax in 2016-17. This is illustrated in Figure 8 on page 21. We undertook a full review of HMRC's estimate in accordance with International Standards on Auditing 540.

Interviews

7 We undertook semi-structured interviews with HMRC staff, including project managers, communications specialists, and senior civil servants. We also spoke to the Scottish Government, HM Treasury, and representatives of the Association of British Insurers, the Association of Taxation Technicians and the Chartered Institute of Taxation.

Previous National Audit Office work

8 We drew on audit findings from our two previous reports on the Scottish rate of income tax.^{25,26}

25 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.

26 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2015-16*, Session 2016-17, HC 871, National Audit Office, December 2016.

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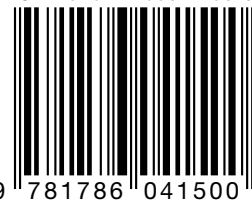


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