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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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.

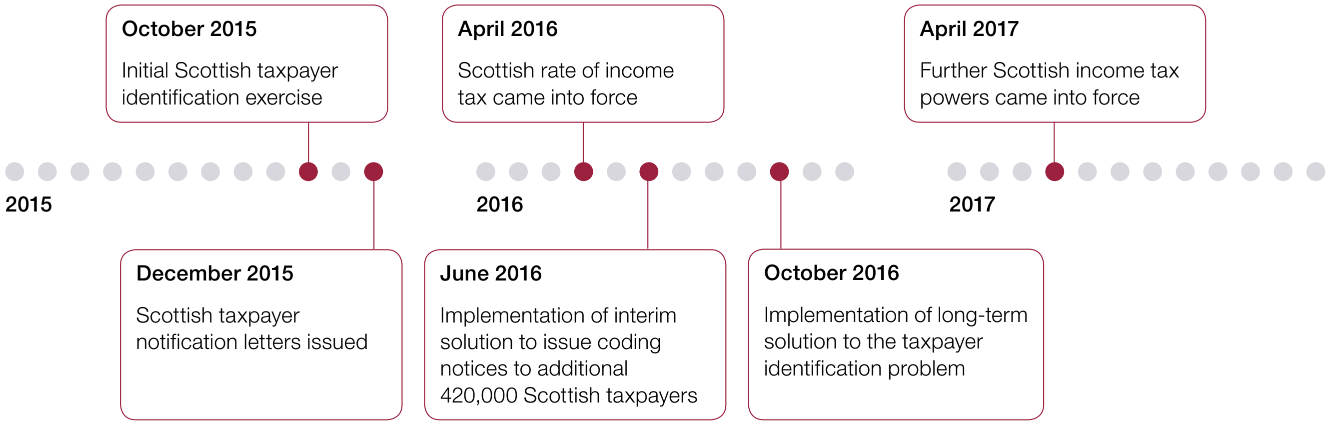
4 In 2017-18, income tax rules in Scotland differ from the rest of the UK for the first time. Scottish taxpayers will pay the higher rate of tax (40%) as soon as they earn £43,000 – as opposed to £45,000 in the rest of the UK. There are no other areas where the UK and Scottish income tax regimes diverge.

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.