National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

Administration of Scottish Income Tax 2017-18

HC 1676 SESSION 2017–2019 30 NOVEMBER 2018
SG/2018/222

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

Administration of Scottish Income Tax 2017-18

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 29 November 2018

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

27 November 2018

HC 1676 | £10.00

SG/2018/222

This report considers the administration of the Scottish income tax in 2017-18.

004129 11/18 NAO

Contents

The National Audit Office study team consisted of:
Matthew Derrick, Benjamin Stern and Simon Wakefield, under the direction of John Thorpe.

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

2.53m
Scottish taxpayers in 2016-17

£4,347m
Scottish rate of income tax revenue in 2016-17, under the 2012 powers

£11,896m
HMRC's estimate of Scottish income tax revenue in 2017-18, under the 2016 powers

£4.5 million Project implementation costs in 2017-18

£0.3 million Costs of administering Scottish income tax in 2017-18

£3.2 million HM Revenue & Customs' (HMRC's) forecast of the remaining project implementation costs

Summary

Introduction

Scottish rate of income tax 2016-17

1 The Scotland Act 2012 reduced UK income tax rates in Scotland by 10 percentage points and gave the Scottish Parliament the power to apply a Scottish rate of income tax. In 2016-17, the Scottish Parliament set the Scottish rate of income tax at 10% of all non-savings, non-dividend income of Scottish taxpayers. The Scottish Government received the income tax revenue generated from the Scottish rate based on a forecast produced by the Office for Budget Responsibility (OBR) in autumn 2015.

2 The 2016-17 tax year was a standalone year before the introduction of the full Scottish income tax powers in April 2017 and there will be no reconciliation or adjustment for any difference between the original forecast and the final outturn, regardless of the actual tax collected by HM Revenue & Customs (HMRC).

3 In our 2016-17 report, we assessed HMRC's latest estimate of the revenue collected from the Scottish rate of income tax. The revenue had to be estimated as the total income tax liabilities could not be known until all of the Pay As You Earn (PAYE) taxpayer accounts were reconciled and the income tax liability data were collected from Self-Assessment taxpayers, which can take up to 10 months after the end of the tax year.

4 HMRC has calculated the final outturn for the 2016-17 Scottish rate of income tax and the calculation is disclosed in the 2017-18 annual report and accounts published in July 2018. As part of this report we provide assurance over HMRC's calculation of this figure from the records of Scottish taxpayers and the impact of estimation for some elements, such as collection rates.

Scottish income tax from 2017-18

5 The Scotland Act 2016 gave the Scottish Parliament full power to determine the rates and thresholds (excluding the personal allowance) paid by Scottish taxpayers on all non-savings, non-dividend income in 2017-18.[1] This represents a significant change from 2016-17, where a Scottish rate of tax was applied to all non-savings and non-dividend income. Under these new powers, in 2017-18 income tax rules in Scotland differed from the rest of the UK for the first time: Scottish taxpayers paid the higher rate of tax (40%) as soon as they earned £43,000 – as opposed to £45,000 in the rest of the UK. There were no other areas where the UK and Scottish income tax regimes diverged.

1 The point at which a taxpayer starts to pay a different rate of tax..

6 HMRC has estimated the revenue collected from Scottish income tax in 2017-18 under the new powers using the same methodology as the previous year. This report provides our view on the calculation of this estimate and highlights potential areas for improvement in future years as Scottish-specific taxpayer data develops.

7 The final outturn for Scottish income tax collected in 2017-18 will be disclosed by HMRC in its 2018-19 annual report and accounts expected to be published in July 2019.

8 For the 2018-19 tax year, the UK and Scottish income tax rules have diverged further. The Scottish Government has introduced two new income tax bands and has varied the rates of the existing higher rate and additional rate income bands. The higher rate threshold will also continue to differ from the UK income tax regime. These changes will only apply to non-savings, non-dividend income. We will report on these changes in more detail in our 2018-19 report.

9 HMRC continues to administer and collect Scottish income tax as part of the UK tax system. Taxpayer records with Scottish addresses are identified in HMRC's systems by a flag which indicates that they are subject to Scottish income tax rates and thresholds. Income tax collected from Scottish taxpayers is paid over to HM Treasury. HM Treasury is responsible for the payment of the Scottish income tax to the Scottish Government.

Remit of the Comptroller and Auditor General

10 Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014, requires the Comptroller and Auditor General (C&AG) 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.

11 This report considers:

- HMRC's calculation of the 2016-17 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account (Part One);
- HMRC's estimation of the 2017-18 income tax revenue attributable to Scotland and our view on the methodology used to estimate the amount (Part One);
- key controls operated by HMRC in the assessment and collection of Scottish income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish rate provisions (Part Two); and
- the cost of administering Scottish income tax and provides assurance on whether the amounts are accurate and fair in the context of the costs incurred by HMRC (Part Three).

Appendix One sets out our audit approach and methodology.

Key findings

Scottish rate of income tax 2016-17 final outturn

12 HMRC calculated the final revenue outturn for 2016-17 as £4,347 million, representing amounts collected under the Scottish rate. We examined the methodology for the calculation of the final outturn, which necessarily includes some remaining areas of estimation. In these areas, we have evaluated the basis of HMRC's estimate including the relevant assumptions and the available data. Based on our procedures, we have concluded that the outturn of income tax revenue for the Scottish rate of income tax for 2016-17 is fairly stated (paragraphs 1.5 to 1.20).

Scottish income tax 2017-18 estimate

13 From 2017-18 onwards, the Scottish Government receives all income tax revenue generated from non-savings, non-dividend income under Scottish income tax policy. HMRC's estimate, published in July 2018, calculated Scottish income tax revenue of £11,896 million for 2017-18. The methodology that HMRC has used for this estimate is consistent with the estimate for the Scottish rate of income tax in 2016-17. The limitations of this methodology remain the same as we reported last year and HMRC plans to refine its estimation methodology now it has a full year of Scottish income tax data for 2016-17 (paragraphs 1.25 to 1.28).

Administering Scottish income tax

14 Under Section 2 of the Exchequer and Audit Departments Act 1921 the C&AG is already responsible for considering the adequacy of the systems HMRC has in place for the assessment and collection of tax in the UK, including income tax. In this year's Standard Report, which accompanies HMRC's annual report and accounts, we concluded that HMRC framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.

15 Having completed our additional work on devolved tax matters, we are satisfied that HMRC has adequate rules and procedures to ensure the proper assessment and collection of Scottish income tax and that they are being complied with (paragraphs 2.15 to 2.19).

Costs

16 In 2017-18 HMRC incurred and recharged £4.8 million of costs on the three Scottish income tax projects, of which £0.3 million was running costs.

17 We examined HMRC's method for estimating the costs of collecting and administering the Scottish income tax for the year to ensure this was reasonable in the context of the agreement with the Scottish Government. Based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2018 is fairly stated (paragraphs 3.2 to 3.5).

Recommendations

a The complete and accurate calculation of the outturn of Scottish income tax revenue is a central responsibility of HMRC's role in devolved taxes. We are content that both parties have a good understanding of the methodology, which has been agreed. We recommend that the methodology is formalised by consolidating it into a single agreed document that forms a baseline position from which future refinements can be made. This will support understanding of the process in the event of changing personnel on either side and reduce the risk that unagreed changes are made to the methodology in the future as better data become available.

b As part of its compliance strategy for Scottish income tax HMRC set out its intention to complete an annual review of its Strategic Picture of Risk (SPR) for Scotland. An updated SPR was not available for review as part of this report. We recommend that HMRC completes this review, incorporating a detailed analysis of the available Scottish taxpayer data for 2016-17, to inform its ongoing compliance work.

Part One

Income tax collected from Scottish taxpayers

1.1 Part One of this report includes HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for the Scottish rate of income tax in 2016-17 and its estimate of Scottish income tax revenue for 2017-18.

1.2 HMRC has calculated the final revenue outturn for 2016-17 as £4,347 million. We examined the methodology for the calculation of the final outturn, which necessarily includes some remaining areas of estimation. In these areas, we have evaluated the basis of HMRC's estimate including the relevant assumptions and the available data. Based on our procedures, we have concluded that the outturn of income tax revenue for the Scottish rate of income tax for 2016-17 is fairly stated.

1.3 HMRC estimates Scottish income tax revenue of £11,896 million for 2017-18. The methodology that HMRC has used for this estimate is consistent with the estimate for the Scottish rate of income tax in 2016-17. The limitations of this methodology remain the same as we reported last year[2] and HMRC plans to refine its estimation methodology now it has a full year of Scottish income tax data for 2016-17.

1.4 This part of the report covers:

- our assessment of HMRC's calculation of the final outturn for revenue collected for Scottish rate of income tax 2016-17 including the data limitations and judgements applied by HMRC in areas of uncertainty within the calculation (paragraphs 1.5 to 1.22); and
- our views on HMRC's estimate of the Scottish income tax revenue for 2017-18 and the features and limitations of HMRC's methodology, including the alternative approaches HMRC could take (paragraphs 1.23 to 1.28).

The Scottish rate of income tax 2016-17 final outturn

1.5 HMRC's calculation of the outturn of income tax revenue for the Scottish rate of income tax for 2016-17 is £4,347 million (**Figure 1** overleaf). This compares with the previous estimate of £4,566 million published in its 2016-17 annual report and accounts in July 2017.[3]

2 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2016-17*, Session 2017–2019, HC 620, National Audit Office, November 2017.
3 HM Revenue & Customs, *Annual Report and Accounts 2016-17*, HC 18, July 2017.

Figure 1

HMRC's calculation of the 2016-17 Scottish rate of income tax revenue

HM Revenue & Customs (HMRC) published the main elements of its calculation in its 2017-18 annual report and accounts

	£ million	£ million
Self Assessment established liability		1,453.67
Pay As You Earn (PAYE established liability)		2,938.40
Estimated further Scottish Rate of Income Tax (SRIT) liability		110.91
Less amounts estimated for:		
Adjustment for uncollectable amounts	(29.98)	
Relief at source (RAS)	(72.99)	
Gift Aid	(53.25)	
		(156.22)
Final revenue for the tax year 2016-17		**4,346.76**

Source: HM Revenue & Customs', *Annual Report and Accounts 2017-18*, HC 1222, July 2018, with alternative rounding

1.6 The previous estimate was based on an estimation of Scotland's share of UK income tax revenue calculated using a simulation model based on the HMRC Survey of Personal Incomes data from 2014-15.[4] The outturn has been calculated primarily using the actual tax liability data that are now available from Pay As You Earn (PAYE) and Self Assessment income tax records.

Methodology for calculating the final outturn

1.7 HMRC has calculated the final outturn figure from several components, which are added together to produce the total Scottish rate of income tax liability for 2016-17. Each component is calculated using one or more sources of data to extract the Scottish income tax liabilities. In some areas of the calculation, the income tax liability data are not available to specifically identify the Scottish share of individual income tax liabilities, reliefs or other adjustments. Therefore, some balances are apportioned between Scotland and the rest of the UK based on other available data.

1.8 For 2016-17 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%. This applied to non-savings, non-dividend income only.

4 The Survey of Personal Incomes is based on a sample of information held by HMRC on individuals who could be liable to UK income tax. It is carried out annually by HMRC and covers income assessable to tax for each tax year. The data it gathers are used to construct an evidence base to inform policy analysis, national statistics, tax modelling and forecasting.

PAYE established liability

1.9 PAYE established liability of £2,938 million represents the sum of all income tax attributable to Scotland under the 2016-17 rate provisions from Scottish PAYE taxpayers. While the total PAYE liabilities are predominantly based upon extraction of specific Scottish taxpayer data from HMRC's systems, some apportionment of other elements is required. **Figure 2** provides a summary of how this has been calculated.

1.10 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees; these data are recorded in the New PAYE System (NPS). Scottish taxpayers are identified in NPS by the S prefix on their tax code. By extracting these taxpayer records HMRC can identify the total income tax liabilities calculated for Scottish taxpayers and the reliefs they have claimed during the year. The reliefs are divided proportionally to all components of income tax which includes a share to the Scottish and UK elements of the total non-savings and non-dividend income tax liability for the year.

1.11 A further adjustment has also been made to apportion the tax collected from employers under settlement agreements, where the identity of individual taxpayers is not recorded and tax liabilities are instead settled on a scheme basis.[5] By analysing the relevant PAYE schemes HMRC has been able to determine the Scottish proportion of each scheme and has allocated settlement agreement revenue according to the Scottish share.

Figure 2
PAYE established liability

The Pay As You Earn (PAYE) established liability includes some estimation to allocate reliefs and income from settlement agreements

	£ million
New PAYE system (NPS) liabilities	2,945.76
Reliefs	(17.86)
PAYE settlement agreements	10.50
Total	**2,938.40**

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

5 A PAYE settlement agreement allows employers to make one annual payment to cover all tax due on minor, irregular or impracticable expenses or benefits for employees in the scheme, reducing the administrative burden of compliance for employers.

Self Assessment established liability

1.12 The Self Assessment established liability of £1,454 million represents the calculation of all income tax attributable to Scotland under the 2016-17 rate provisions from Scottish Self Assessment taxpayers. As for PAYE, Self Assessment liabilities are predominantly based upon the extraction of specific Scottish taxpayer data from HMRC's systems, with apportionment of other balances where necessary. **Figure 3** provides a summary of how this has been calculated.

1.13 Scottish taxpayers are identified within the Computerised Environment for Self Assessment (CESA) by the 'Scottish indicator' flag on their account. By extracting these taxpayer records HMRC can identify the total income tax liabilities calculated for Scottish taxpayers and the reliefs they have claimed during the year. The reliefs are divided proportionally to all components of income tax which includes a share to the Scottish and UK elements of the total non-savings and non-dividend income tax liability for the year.

1.14 Minor adjustments have also been made to apportion to Scotland its share of other relevant Self Assessment balances where specific data are not available, including:

- manually entered liabilities using the "Create Return Charges" function within CESA that does not provide a split of the liability between taxes; and
- tax revenue raised from compliance activity relating to Self Assessment.

Estimated further liability

1.15 Most of the Self Assessment liabilities for 2016-17 have been established; however, HMRC's analysis of data from previous years demonstrates that Self Assessment tax liabilities will continue to be established and collected for up to six years after the end of the tax year.

Figure 3
Self Assessment established liability

The Self Assessment established liability includes some estimation to allocate reliefs and adjustments for other minor items

	£ million
Self Assessment (CESA[1]) liability	1,476.27
Reliefs	(28.09)
Manually entered liabilities	5.42
Assessments	0.07
Total	**1,453.67**

Note
1 CESA = Computerised Environment for Self Assessment.

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

1.16 HMRC has identified two specific sources of revenue for which it does not currently hold complete 2016-17 data but where it expects to establish liabilities in the future:

- further liabilities that are expected to be established as additional information is received from taxpayers; and
- tax revenue that is expected to be generated because of ongoing and future compliance activity.

In both cases, the additional amounts used in the calculation of the outturn have been estimated based on historical data to determine the pattern of liabilities established after the reporting deadline for each tax year, reflecting what HMRC ultimately expects to collect. These are included in **Figure 4**.

Deductions from revenue

1.17 To calculate the final outturn HMRC made some further adjustments that have the impact of reducing the revenue outturn (**Figure 5**). HMRC has calculated these adjustments by using historical information to apportion the Scottish share of the total balance in each case.

Figure 4
Estimated further liability

HM Revenue & Customs (HMRC) knows that further liabilities will be established for up to six years from new information and compliance activity

	£ million
Further Self Assessment liabilities	83.23
Self Assessment settlement agreements	27.68
Total	**110.91**

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

Figure 5
Deductions from revenue

HM Revenue & Customs (HMRC) has made some estimates for collection losses and other costs that will ultimately reduce the amount of tax collected

	£ million
Relief at source	72.99
Gift Aid	53.25
Pay As You Earn (PAYE) – uncollectable amounts	18.97
Self Assessment – uncollectable amounts	11.01
Total	**156.22**

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

1.18 Pension contributions attract income tax relief at the basic rate. Pension administrators claim the relief from HMRC on behalf of their scheme members. HMRC has apportioned the Scottish share of total pension relief in 2016-17 based on analysis of pensions data from 2015-16, the latest available data.

1.19 Gift Aid relief is available on charitable donations at the basic rate. Charities claim the relief from HMRC on behalf of their donors. HMRC calculated the total Gift Aid relief for 2016-17 by combining the actual claim payments to date with a forecast of future claims based on analysis of historical data. The Scottish share of the total has been apportioned using the mean average of two apportionment methods; the Scottish share of income compared with total income and the number of Scottish taxpayers compared with the total number of taxpayers.

1.20 There will be a portion of PAYE and Self Assessment income tax liabilities, which are never fully settled. This is due to employers or taxpayers failing to pay the full amount due. HMRC has analysed historical data from the whole of the UK to determine the pattern of uncollected liabilities. The historical pattern has been used to estimate the amounts that relate to 2016-17 tax liabilities that will not be collected.

Agreement with the Scottish Government

1.21 HMRC and the Scottish Government have maintained effective communication during the development of the detailed methodology used to calculate the 2016-17 revenue outturn. This has involved:

- HMRC producing an initial paper in 2014 setting out the high-level methodology;
- regular discussion of the detailed methodology as it developed, including areas where estimation would be required; and
- HMRC providing details of the final methodology including the data inputs, significant assumptions and calculation processes.

The methodology used to calculate the outturn and summarised in this report was agreed by both parties.

1.22 The complete and accurate calculation of the outturn of Scottish income tax revenue is a central responsibility of HMRC's role in devolved taxes. We are content that both parties have a good understanding of the agreed methodology. We recommend that the methodology is formalised by consolidating it into a single agreed document that forms a baseline position from which future refinements can be made. This will support understanding of the process in the event of changing personnel on either side and reduce the risk that unagreed changes are made to the methodology in the future as better data become available.

Scottish income tax 2017-18

1.23 From 2017-18, the Scottish Government receives all revenue generated from the taxation of non-savings, non-dividend income, not just the portion generated from the Scottish rate. HMRC estimated earlier this year that it will collect £11,896 million of Scottish income tax revenue relating to 2017-18.[6] The final outturn for the 2017-18 year will be calculated in May 2019 and it is expected to be published in HMRC's 2018-19 annual report and accounts.

1.24 The 2017-18 tax year will be the first year for which a reconciliation will be completed between the original budget forecast and the final outturn, when it is known. Any differences between the forecast and the final outturn will be adjusted in a future Scottish budget. The details of the budget reconciliation process are included in our previous report.[7]

HMRC's revenue estimate for 2017-18

1.25 HMRC's methodology to estimate the Scottish income tax revenue for 2017-18 is consistent with the estimate for the Scottish rate of income tax revenue for 2016-17. It is based on taxpayer data from 2015-16 extracted for its Survey of Personal Incomes, analysed in a model replicating the UK income tax system known as the Personal Tax Model from which Scotland's share of the overall UK income tax liability is determined. Due to the change in powers, the share of the total UK income tax allocated to Scotland in 2017-18 has increased to 7.13% from 2.88%.

1.26 The Scottish share was then applied to the total UK tax liability, which is calculated by combining actual PAYE receipts from 2017-18 with an estimate of Self Assessment liabilities for 2017-18. **Figure 6** overleaf provides further details of the methodology.

1.27 As the methodology for estimating Scottish income tax revenue is unchanged, the limitations that were outlined in our previous report are still applicable in 2017-18.[8] These are:

- the use of sample data introduces sampling uncertainty into the estimate of revenue from which the Scottish portion is calculated as a percentage;
- the method combines the calculation of PAYE and Self Assessment liabilities for the UK so the amount apportioned to Scotland does not reflect the differing proportions of each type of taxpayer between Scotland and the rest of the UK;
- the data used for PAYE includes all income types, it does not exclude non-savings and non-dividend income; and
- an assumption must be made around the volume and value of under- and overpayments relating to PAYE liabilities.

6 HM Revenue & Customs, *Annual Report and Accounts 2017-18*, HC 1222, July 2018.
7 See footnote 2.
8 See footnote 2.

Figure 6

Method for calculating the 2017-18 revenue estimate

The revenue estimate relies upon sample data and an apportionment of UK-wide estimates to calculate a Scottish share of income tax revenue

Survey of Personal Incomes

HM Revenue & Customs (HMRC) collected data from a 1.5% sample of UK taxpayers in 2015-16[1]

→

Personal Tax Model

HMRC calculated the percentage share of income tax that was Scottish: 7.12%

→

Adjustments

HMRC adjusted for changes to population and tax legislation between 2015-16 and 2017-18: 7.13%

→

Total UK income tax liability 2017-18

HMRC combined Self Assessment liabilities[2] with PAYE receipts to calculate the total liability for the UK[3]: £168.9 billion

→

Scottish rate of income tax 2017-18 revenue estimate

HMRC applied the proportion to the total income tax liability for 2017-18 to give an estimate[4]: £11.9 billion

Notes

1 HMRC's annual Survey of Personal Incomes is a sample of UK taxpayers' data from the Pay As You Earn (PAYE) and Self Assessment tax systems. The Personal Tax Model (PTM) projects the outcome for income tax liabilities in 2017-18, taking into account the full Scottish income tax powers and adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Scottish share.

2 Annex B: Data sources and methodology, *HMRC UK Income Tax Liabilities Statistics; 2015-16 Survey of Personal Incomes with projections to 2018-19*, Released: 25 May 2018.

3 Non-savings non-dividend income only.

4 PAYE data come from Real Time Information, and Self-Assessment data come from HMRC's Self-Assessment Model.

5 To obtain the estimate of £11.9 billion, there are three small adjustments made to account for factors not addressed by the PTM.

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

1.28 Using this methodology last year, HMRC estimated that the revenue arising from the Scottish rate of income tax for 2016-17 would be £4,566 million, the final outturn has been reported this year as £4,347 million. This represents an over-estimation of around 5%. HMRC plans to refine its estimation methodology now it has a full year of Scottish income tax data for 2016-17.

Part Two

Administering Scottish income tax

2.1 Part Two of this report includes a summary of HM Revenue & Customs' (HMRC's) systems and procedures for the assessment and collection of income tax under the Scottish rate provisions. We have also examined HMRC's approach to implementing the relief at source project, its maintenance of address records and its identification and treatment of compliance risk.

2.2 Under Section 2 of the Exchequer and Audit Departments Act 1921 the Comptroller and Auditor General is already responsible for considering the adequacy of the systems HMRC has in place for the assessment and collection of tax in the UK, including income tax. In this year's Standard Report, which accompanies HMRC's annual report and accounts, we concluded that HMRC framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.[9]

2.3 Having completed our additional work on devolved tax matters, we are satisfied that HMRC has adequate rules and procedures to ensure the proper assessment and collection of Scottish income tax and that they are being complied with.

2.4 In reaching our conclusions on these rules and procedures we have also examined several other elements of devolved tax administration including the progress of the relief at source project, the ongoing maintenance of Scottish taxpayer records and the identification and response to devolved tax compliance risks.

2.5 This part of the report covers:

- HMRC's key processes in administering the income tax system and our approach to assurance (paragraphs 2.6 to 2.19);
- progress on implementing the relief at source project for administering tax relief on pensions contributions (paragraphs 2.20 to 2.24);
- procedures used to identify and maintain a complete and accurate record of the Scottish taxpayer population (paragraphs 2.25 to 2.29); and
- activity undertaken by HMRC to identify and respond to compliance risks (paragraphs 2.30 to 2.38).

9 Report by the Comptroller and Auditor General, *HM Revenue & Customs 2017-18 Accounts*, HC 1222, July 2018.

The income tax system

2.6 The income tax system is consistent across the UK. Depending on the type of income that an individual receives, income tax will be assessed and collected by employer's deductions from earnings through Pay As You Earn (PAYE), the taxpayer submitting a Self Assessment return, or both.

2.7 The PAYE and Self Assessment processes have common principles, despite utilising different IT systems and data sources to assess and collect tax. **Figure 7** overleaf identifies these principles and describes the main processes for each income tax stream.

2.8 Taxpayer information is submitted to HMRC through several channels. For PAYE, employers and pension providers complete monthly data submissions containing information about individuals' earnings, pension payments and tax deductions. Self Assessment taxpayers complete an annual submission containing details of all the income they have received during the tax year.

2.9 The submissions processing systems complete data validation checks and then route the information to the appropriate tax processing system. A matching function identifies the relevant taxpayer record and stores the new data or updates the existing information in the relevant database.

2.10 The tax processing system consolidates all the available data to produce a total income figure for each taxpayer and calculates the associated income tax liability using the relevant business rules.[10] The output from the income tax liability calculation is then stored on the appropriate taxpayer record.

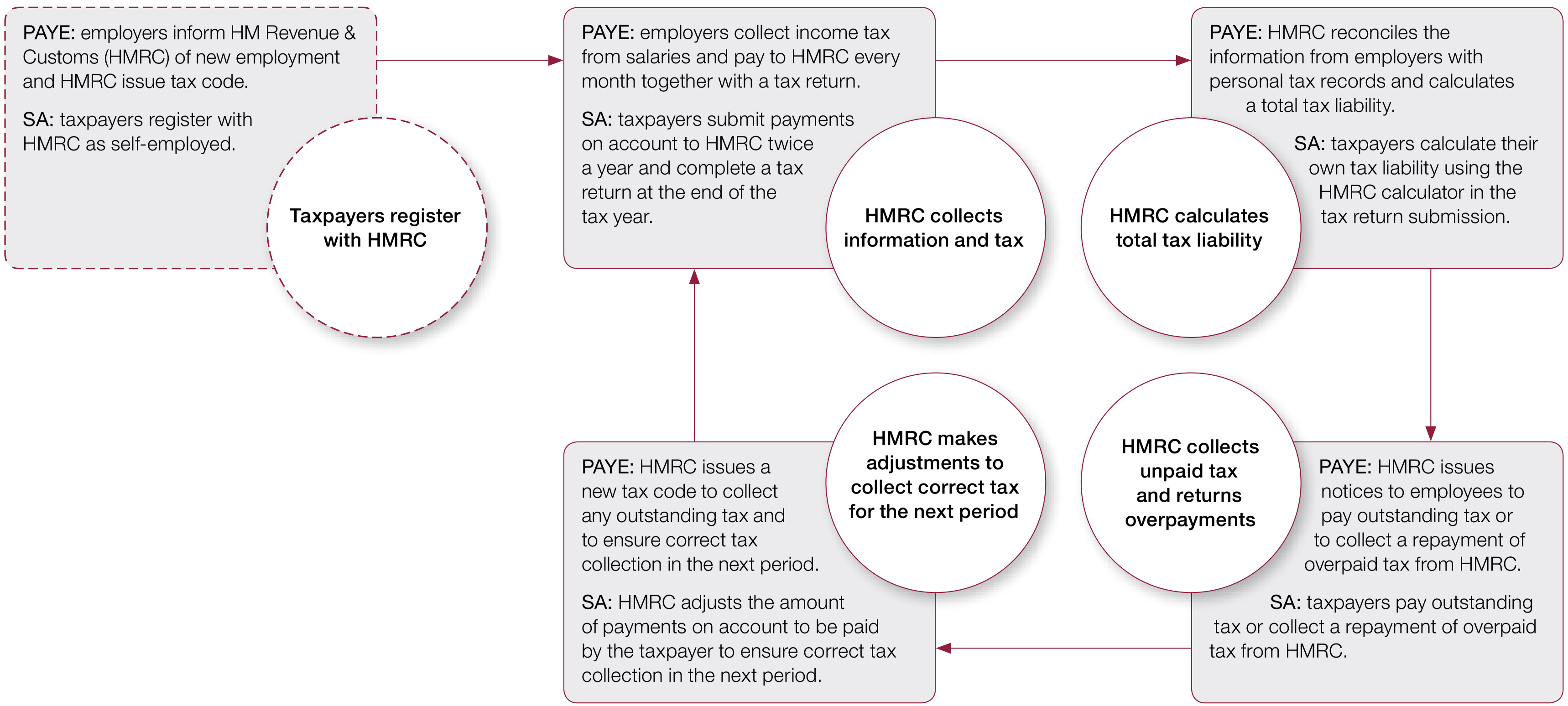
2.11 The calculated tax liability is compared with the amounts deducted at source or collected from taxpayers directly through payments on account. The reconciliation determines whether the correct amount of tax has been collected. Where tax has been underpaid this will be collected from the taxpayer or overpaid tax will be refunded.

2.12 For PAYE taxpayers, tax codes are recalculated based on the latest tax liability data and, if necessary, HMRC will update the tax code for the forthcoming tax year by issuing a coding notice to the taxpayer and the employer.

10 Business rules contain data relevant to the calculation of tax liabilities and they are used by each tax processing system to calculate income tax liabilities based on income data. The rules include, but are not limited to, the application of tax codes and the rates and thresholds that apply to each type of income based on residency. Business rules are updated annually to reflect changes in tax policy.

Figure 7
The income tax system

The Pay As You Earn (PAYE) and Self Assessment (SA) processes share common principles in the assessment and collection of income tax



Note

1 PAYE and Self Assessment processes do not occur simultaneously. PAYE is processed during the tax year and reconciled after the end of the tax year. Self Assessment returns are not submitted until the January following the end of the tax year.

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

Devolved income tax

2.13 The administration of devolved taxes diverges from the UK processes only in the business rules that the system applies when completing the tax liability and tax code calculations. These rules are:

- the system checks the residency status of the individual and applies or removes the 'S' code prefix or flag;
- where an individual has been identified as Scottish, the Scottish tax rates and bands are applied to the reported income to calculate the liability for the current tax year; and
- if an individual has been identified as Scottish and they are enrolled on a PAYE scheme, the system uses the Scottish income tax rates and thresholds to calculate a new tax code for the following year.

Figure 8 shows where these divergences occur within the income tax system.

2.14 The correct application of these business rules is dependent upon the completeness and accuracy of address data that HMRC holds for each taxpayer, and the maintenance of a master list of UK addresses that confirms which are Scottish.

Assurance of income tax processing

2.15 Our annual programme of audit work in HMRC includes procedures that provide assurance over the key tax processing controls. These controls can be broadly divided into two categories:

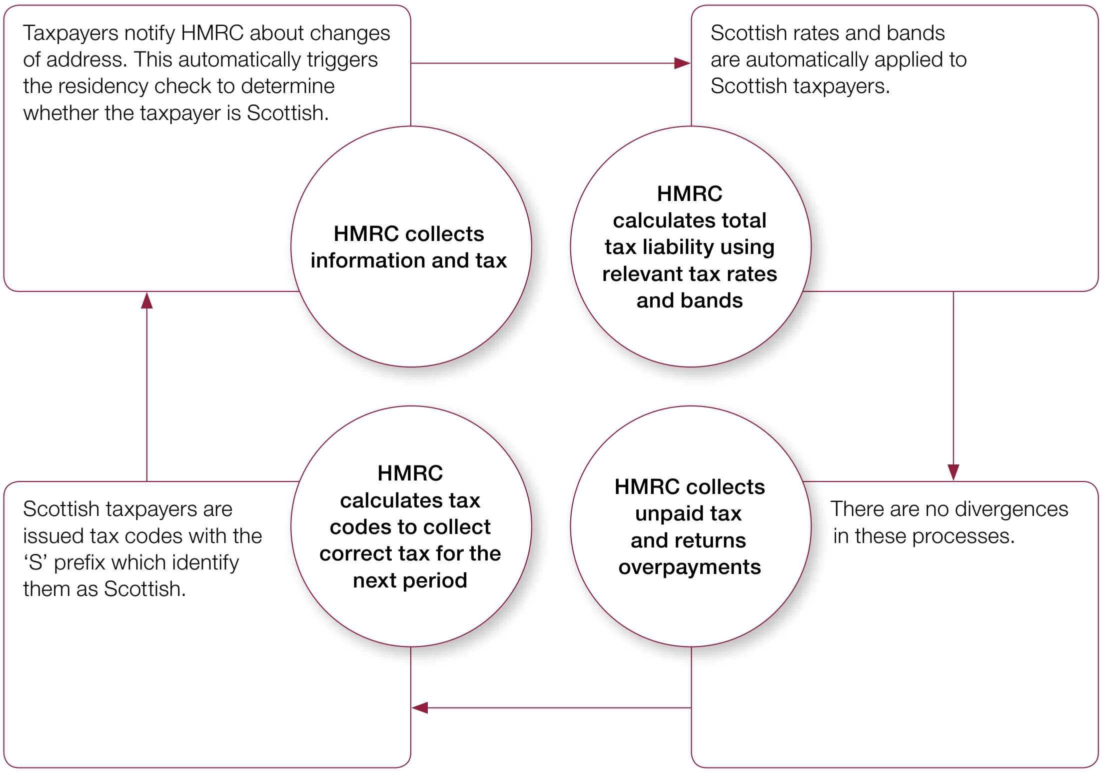
- automated system controls around data-handling, storage and processing; and
- key business controls that have a high level of automation but are complex.

2.16 To assure the automated system controls we map the system functionality of the income tax cycle and confirm that the automated controls are implemented appropriately. These controls include the:

- processing of data submissions, including basic data format and validation checks;
- transferring of data between systems and ultimately to the correct tax system;
- matching of data to the correct taxpayer record and updating it as necessary; and
- application of the appropriate business rules to the calculation processes for each taxpayer – including their residency status for devolved tax purposes.

Figure 8
Divergences in the income tax system

The business rules are configured to process income tax using the rates and thresholds applicable to a taxpayer's residency status



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

2.17 For the key business controls HMRC completes several phases of assurance testing to confirm system functionality following the annual updates to business rules that reflect changing tax rates, thresholds and allowances for the UK and the devolved administrations. As part of our audit we evaluate the scope of this testing and re-perform elements of the work to confirm HMRC's conclusions. The key processes in PAYE include the:

- annual reconciliation of PAYE taxpayers to confirm tax due on earnings and any over-or underpayments of tax; and
- annual coding for PAYE taxpayers, which incorporates a residency assessment against the recorded address for devolved tax purposes.

Similar processes are applied to each individual Self Assessment return once it is received by HMRC.

2.18 To support the conclusions of this report our UK-wide testing is extended to incorporate the specific divergences caused by devolution. We also undertake specific procedures around address cleansing and tax compliance to inform our assessment of the completeness of Scottish income tax (see paragraphs 2.25 to 2.38).

2.19 Our overall assessment of HMRC's systems for collecting tax across the UK is included in the Standard Report.[11] Having completed our additional work on devolved tax issues, we are satisfied that HMRC has adequate rules and procedures to ensure the proper assessment and collection of Scottish income tax and that these are being complied with.

Tax relief on pension contributions

2.20 In our previous report, we outlined HMRC's plans for implementing a new system for administering tax relief for pension contributions. It is important that Scottish taxpayers are identified within each pension scheme so that tax relief is allocated correctly.

2.21 In 2017-18, income tax rates were the same in Scotland and the rest of the UK, although the higher rate threshold was different. In 2018-19, Scotland will introduce different rates and bands, and this means that the rates of relief will also differ. Relief at source will continue to be applied at the basic rate of 20% for all taxpayers.[12] Scottish taxpayers who pay tax at a rate above 20% will be able to claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

2.22 To administer relief at source, HMRC requires that all providers submit an annual report in a specified format, listing all member contributions in the previous tax year. From April 2019 it will be mandatory for pension providers to use HMRC's online Secure Data Exchange Service (SDES) to submit returns.

2.23 HMRC has not yet introduced automatic processing of the residency status of scheme members. A temporary process was in place during 2017-18 to notify pension providers of the residency status of their members. HMRC issued 1,000 notification reports covering more than 29 million pension members under the temporary process.

2.24 In January 2018, HMRC launched a secure look-up service, which allows pension providers to look up new members individually or in batches and check their residency status. HMRC expects that the new automated system will be in place in April 2019 (**Figure 9**).

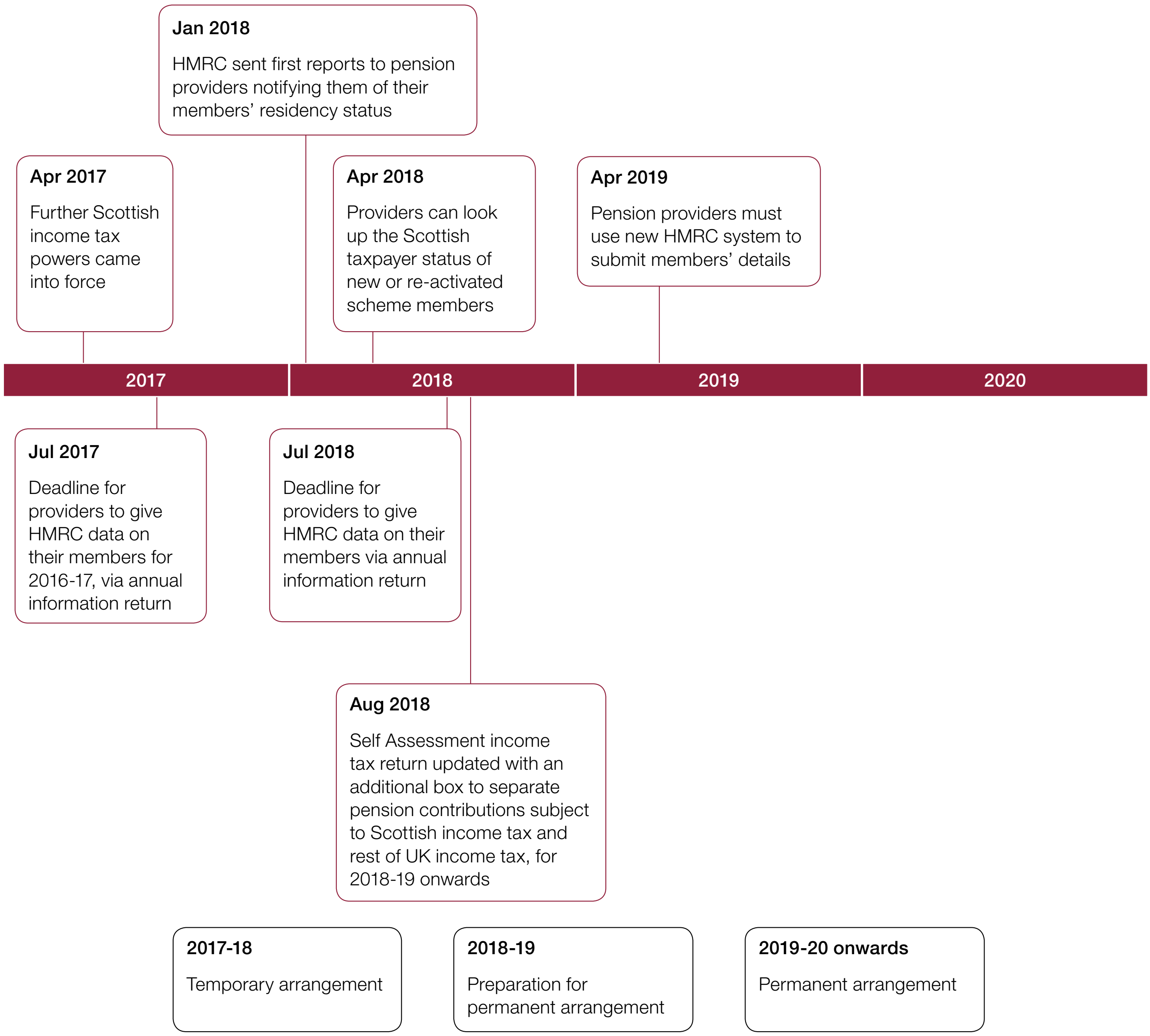
11 See footnote 9.

12 Relief at source is the portion of tax relief that is automatically applied to pension contributions. Pension providers claim this relief from HMRC on behalf of their members.

Figure 9

Relief at source timeline

The new HM Revenue & Customs (HMRC) system will be implemented from April 2019 when pension providers will be required to complete returns using the Secure Data Exchange Service (SDES)



Source: National Audit Office analysis of HM Revenue & Customs project plans

Scottish taxpayer population

2.25 Identifying the Scottish taxpayer population continues to be the main challenge to HMRC in administering Scottish income tax. HMRC undertakes a programme of annual checks on the overall taxpayer population.

Assurance of address information

2.26 To ensure that the right amount of tax is collected from individuals and allocated to the appropriate government it is essential that address information is correct. HMRC has implemented several assurance processes to maintain the completeness and accuracy of the Scottish taxpayer population (**Figure 10**). Where errors or inconsistencies have been identified HMRC has, or plans to take, corrective action.

Figure 10

Assurance of the taxpayer population

HM Revenue & Customs (HMRC) is undertaking a number of assurance activities designed to maintain the completeness of the Scottish tax base

Assurance activity	Purpose	Results
Tax code scans	A comparison of tax codes in Pay As You Earn (PAYE) submissions with the taxpayer record to identify cases where the employer is operating a different tax code to HMRC.	91,304 cases identified where the 'S' code is not being operated as expected by the employer.[1]
Postcode scan	A comparison of HMRC's framework list of Scottish postcodes with data from National Records Scotland to ensure HMRC's list is kept up-to-date.	208 new postcodes were added 309 postcodes were removed
Address cleansing	A scan of taxpayer records to identify blank, missing, incomplete postcodes which may result in the incorrect residency status being applied.	3,660 records were flagged for review
Third-party data clash	A comparison of taxpayer address records with third-party data sources to identify cases where HMRC records are inconsistent with third-party data.	9,177 inconsistences were identified

Notes

1 This is an employer compliance issue only and does not impact the tax revenue allocated to Scotland as HMRC has correctly identified these individuals as Scottish taxpayers.

2 Note listing examples of the third-party data sets used in the third-party data clash activity.

Source: National Audit Office summary of HM Revenue & Customs activities

Number of Scottish taxpayers

2.27 HMRC originally estimated that there were 2.58 million Scottish taxpayers in 2016-17.[13] A Scottish taxpayer is someone with a tax liability whose main place of residence in a given tax year is Scotland.[14] In our previous report, we outlined HMRC's rules and procedures for determining a taxpayer's residency status when address information is updated; these processes are now embedded as business-as-usual.[15]

2.28 To calculate the revenue outturn for 2016-17, HMRC extracted all the reconciled records for Scottish taxpayers from its PAYE and Self Assessment systems. These extractions directly identified 2.51 million taxpayers. HMRC also estimates that there are around 23,000 Scottish Self Assessment taxpayers with unestablished liabilities. As a result, HMRC reports that there are 2.53 million Scottish taxpayers in 2016-17 (**Figure 11**), which is 1.9% lower than the original estimate.

2.29 Based on the latest Survey of Personal Incomes published in May 2018, HMRC estimates there are 2.59 million Scottish taxpayers in 2017-18.

Figure 11
Number of Scottish taxpayers in 2016-17

The number of Scottish taxpayers for 2016-17 remains a partial estimate because of the timing of the Self Assessment process

	Number of taxpayers
Pay As You Earn (PAYE)	2,065,106
Self Assessment[1]	439,961
Total of known taxpayers	**2,505,067**
Estimate of Self Assessment unestablished liabilities[2]	23,351
Expected total number of taxpayers	**2,528,418**

Notes

1 Includes all Self Assessment taxpayers with established liabilities.

2 HM Revenue & Customs has estimated the number of Self Assessment taxpayers with unestablished liabilities.

Source: HM Revenue & Customs analysis of Scottish income tax data

13 Comptroller and Auditor General, *The administration of the Scottish Rate of Income Tax 2016-17*, Session 2017–2019, HC 620, National Audit Office, November 2017.

14 This definition therefore excludes individuals who earn less that the personal allowance or those, for other reasons, that have income but no tax liability – for instance, because they have claimed a relief that reduces their potential liability to nil or had no taxable income during the year.

15 See footnote 13.

Compliance risks

2.30 As we outlined in our previous reports, HMRC tackles 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.[16]

HMRC continues to assess risk and undertake compliance activity into the overall tax affairs of Scottish taxpayers as it does with the rest of the UK taxpayer population.

2.31 HMRC's assessment of compliance risk specific to Scottish income tax is based on its Strategic Picture of Risk (SPR), which uses analysis of a subset of the whole of UK data plus the findings from specific work undertaken by the specialist teams that monitor wealthy individuals and large companies.

2.32 The SPR assessment is central in informing the Scottish compliance strategy and it is usually updated each year. This was last updated in September 2017 using 2014-15 data for Self Assessment taxpayers and 2015-16 data for PAYE taxpayers. The previous SPR included:

- analysis of the Scottish taxpayer population and associated tax liabilities;
- an assessment of the overall income tax risks and the impact for Scotland; and
- estimates of the potential tax loss for each of the identified risks.

2.33 We were expecting the updated SPR, incorporating the latest income tax data and refreshed Scottish income tax risks, to be available for review to inform the findings of this report. Although we have been able to discuss its risk assessment work with HMRC, it is in the process of completing this work. We recommend that HMRC updates the SPR as soon as possible, incorporating a detailed analysis of the available Scottish taxpayer data for 2016-17, to inform its ongoing compliance work.

Compliance risk in 2017-18

2.34 HMRC recognises that the greater the divergence between Scottish income tax and the rest of UK income tax, the greater the risk and impact of non-compliance. In 2017-18, the difference between Scottish rates and thresholds and the rest of the UK was minor and affected a relatively small proportion of the taxpayer population. Therefore, HMRC assessed the risk of non-compliant behaviour to be extremely low.

16 See footnote 13.

2.35 HMRC considers the main areas of risk of non-compliance in 2017-18 to be the same as previously assessed. These are:

- a failure to notify HMRC of a change of address;
- the deliberate manipulation of address information;
- the switching of earnings from income to capital; or
- contrived employment structures to reduce income tax liabilities.

2.36 HMRC has provided its Scottish Income Tax Annual Report 2018 to the Finance and Constitution Committee of the Scottish Parliament, which includes details of the planned compliance activities to mitigate these risks, some of which we have highlighted in Figure 10.[17] We will examine the results of this compliance work as they become available.

Risk assessment in 2018-19 and beyond

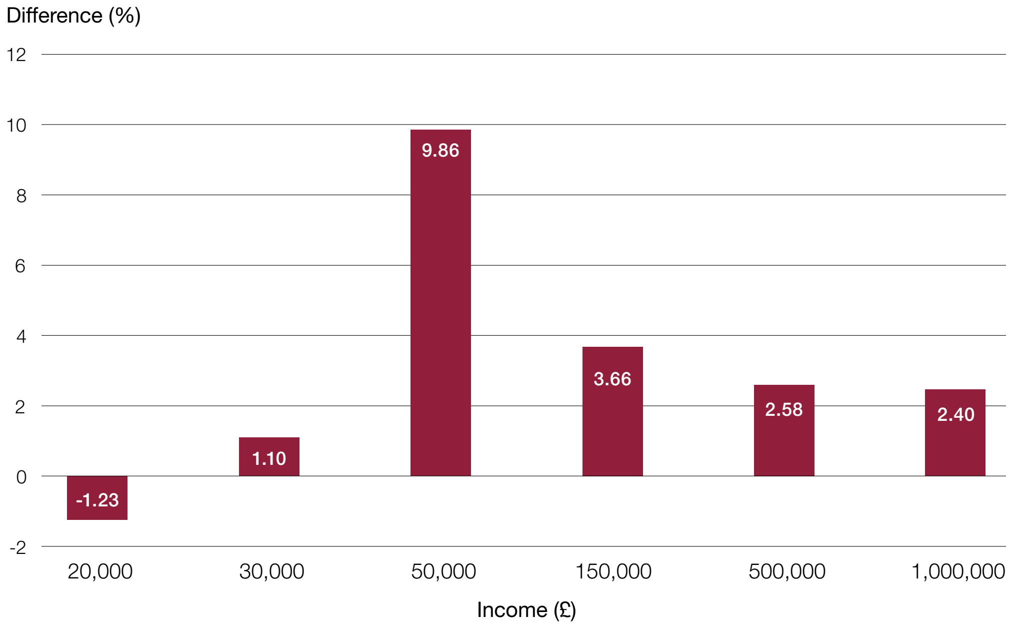
2.37 In 2018-19, the tax regimes of Scotland and the rest of the UK will diverge further with the introduction of additional rates and bands in Scotland. HMRC considers that the risk of non-compliance through incorrect residency status will remain low for many taxpayers due to the relatively small difference in tax liability. Once the SPR is available for review, we are interested in discussing HMRC's assessment of compliance risk for those taxpayers where the relative increase in tax is greatest (**Figure 12** overleaf).

2.38 HMRC considers that the greater risk to income tax revenue in Scotland is from non-compliant behaviour from high earners with the aim of avoiding or reducing income tax liabilities altogether, such as incorrectly reporting or disguising income. These risks are not specific to Scotland and are considered as part of HMRC's overall compliance strategy for income tax.

17 HM Revenue & Customs, *Scottish Income Tax Annual Report 2018*, Scottish Parliament, Finance and Constitution Committee, FCC/S5/18/25/A, September 2018.

Figure 12
Difference in tax liability between a Scottish and a UK taxpayer in 2018-19

The difference in the tax liability for a Scottish taxpayer is small relative to an equivalent UK taxpayer but the relative impact varies across income levels



Income (£)	Scottish income tax (£)	UK income tax (£)	Difference (£)
20,000	1,610	1,630	-20
30,000	3,670	3,630	40
50,000	9,184	8,360	824
150,000	55,043	53,100	1,943
500,000	216,043	210,600	5,443
1,000,000	446,043	435,600	10,443

Note

1 This illustration assumes that a taxpayer has only non-savings, non-dividend income during the year and has a full Personal Allowance. It does not include any other allowances or reliefs.

Source: National Audit Office analysis of income tax in Scotland and the UK for 2018-19

Part Three

Costs

3.1 This part considers the administrative costs of Scottish income tax and whether these costs are reasonable.

3.2 Under the service level agreement between HM Revenue & Customs (HMRC) and the Scottish Government, the Scottish Government is required to reimburse HMRC for "net additional costs wholly and necessarily incurred as a result of the administration of the Scottish income tax powers".

3.3 A supporting framework sets out the principles for identifying net additional costs. HMRC recharges costs that can be validated as specifically related to the administration of devolved Scottish income tax powers and not the costs of administering the overall income tax system in Scotland.

Costs incurred in 2017-18

3.4 In 2017-18 HMRC invoiced the Scottish Government for £4.8 million of costs on the three Scottish income tax projects, of which £0.3 million was running costs.

3.5 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 in the context of the agreement with the Scottish Government. Based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2018 is accurate and fair.

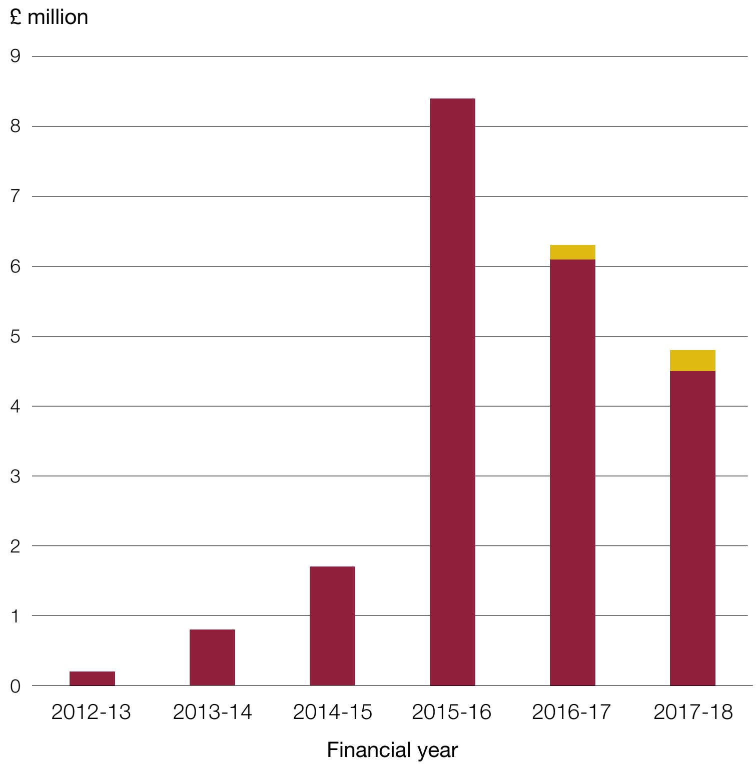
Estimated total cost of implementing the Scottish rate of income tax

3.6 From 2012-13 to 2017-18 HMRC has spent a total of £21.7 million on implementing the Scottish rate of income tax and two associated projects: further Scottish income tax powers and relief at source. HMRC expects to spend a further £3.2 million on implementation over the remaining lifecycle of the project, primarily to deliver the relief at source system. **Figure 13** overleaf provides a summary of costs to date.

Figure 13

Actual spending on Scottish income tax projects from 2012-13 to 2017-18

Spending is moving from implementation costs to running costs as the projects draw to a close



	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Implementation costs	0.2	0.8	1.7	8.4	6.1	4.5
Running costs	0	0	0	0	0.2	0.3

Notes

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 may not sum due to rounding.

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

Appendix One

Our audit approach

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

- the adequacy of any of HM Revenue & Customs' (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.

2 To reach the conclusions set out in this report in relation to the rules and procedures operated by HMRC we have drawn directly from our statutory audit work on HMRC's annual report and accounts, including the C&AG's report on the controls operating within HMRC over the proper assessment, collection and allocation of tax under Section 2 of the Exchequer and Audit Departments Act 1921. We have also completed specific audit procedures over controls relevant to the administration of devolved taxes.

3 We have audited the data, methodologies, assumptions and mechanics of the calculation of revenue outturn for 2016-17 that are described in this report. Where the outturn calculation relies upon estimation, this work has been planned and completed by applying the principles set out in International Standards on Auditing (UK) 540 Auditing Accounting Estimates and Related Disclosures to design audit procedures relevant to the nature of the estimates and to a sufficient level of precision.

4 In relation to administration costs our conclusion on the accuracy and fairness of the costs charged to the Scottish Government is based upon an evaluation of the costs against the details of the service level agreement and the supporting framework for costs agreed between both parties. Some of the costs incurred are estimated by HMRC from available data on customer contacts and staff time. During the audit we also obtained evidence that both parties regularly discuss and review the cost budgets and forecasts as well as agreeing the amounts to be invoiced and paid.

5 All of these audit procedures have been planned, performed and reviewed in accordance with our internal quality control procedures for financial audit.

6 To present HMRC's approach to compliance risk we have reviewed published and unpublished HMRC documents about the Scottish rate of income tax, including project documentation, risk and compliance documentation and the details of key assurance work being performed by the Department.

7 This document review has been supplemented by semi-structured interviews with HMRC staff in a number of areas of the business. We also spoke to the Scottish Government and Audit Scotland to inform our risk assessment and planning work for this report.

8 We reached our findings following our analysis of evidence collected between May and October 2018.

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 978-1-78604-221-7

9 781786 042217

Design and Production by NAO External Relations
DP Ref: 004129-001