National Audit Office

REPORT

Administration of Welsh rates of income tax 2021-22

HM Revenue & Customs

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National Audit Office

Administration of Welsh rates of income tax 2021-22

HM Revenue & Customs

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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Key facts

1.4mn
Welsh taxpayers in 2020-21

£2.14bn
Welsh income tax revenue in 2020-21

£2.36bn
HM Revenue & Customs' estimate of Welsh income tax revenue in 2021-22

£0.4 million costs of administering Welsh income tax in 2021-22

Summary

Introduction

Welsh income tax

1 The Wales Act 2016 gave the Senedd (Welsh Parliament) power to determine the rates (excluding the personal allowance) paid by Welsh taxpayers on all non-savings, non-dividend income, from 6 April 2017. The Welsh Government receives all income tax revenue generated from non-savings, non-dividend income under Welsh income tax policy.

2 From April 2019, the UK government reduced the UK basic, higher and additional income tax rates by 10 percentage points for Welsh taxpayers and the Senedd had the power to apply Welsh rates in addition. For each tax band, the rate of income tax paid is the sum of the reduced rest of UK rate and the new Welsh rate (**Figure 1** overleaf). For 2021-22, the Senedd set the Welsh rates of income tax the same as in 2020-21, at 10% across all bands, which meant that the total rates for taxpayers in Wales matched the UK rates at 20% (basic rate), 40% (higher rate) and 45% (additional rate).

Roles and responsibilities

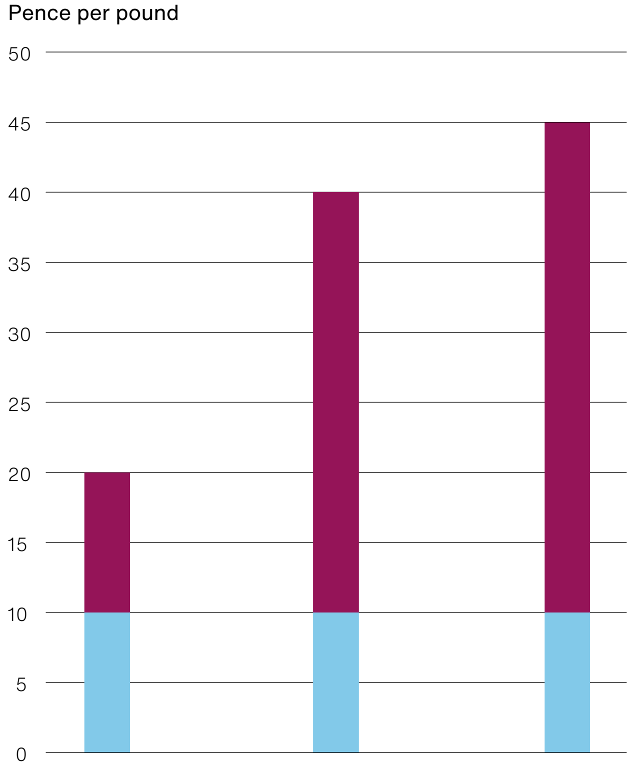
3 HM Revenue & Customs (HMRC) administers and collects Welsh income tax as part of the UK tax system. HMRC identifies taxpayers living in Wales by applying a 'flag' in its systems that indicates they are subject to Welsh income tax rates. HMRC has calculated that there were 1.4 million Welsh taxpayers in 2020-21. HM Treasury is responsible for paying Welsh income tax to the Welsh Government.

4 Following the end of each tax year, HMRC produces a provisional estimate of Welsh income tax revenue for that year. The final outturn is calculated the following year once HMRC receives further information from taxpayers and employers. This report covers the final outturn for 2020-21 and the provisional estimate for 2021-22. HMRC expects to publish the outturn for 2021-22 in its 2022-23 Annual Report and Accounts.

Figure 1

Welsh rates of income tax for 2021-22

The UK rates of income tax are effectively reduced by 10 pence per pound and replaced with the Welsh rates of income tax



	Basic rate	Higher rate	Additional rate
UK income tax rate reduced by 10 pence per pound (pence per pound)	10	30	35
Welsh rate of income tax (pence per pound)	10	10	10
Total (pence per pound)	**20**	**40**	**45**

Notes

1 For each tax band (basic, higher and additional), the UK government reduces the amount of tax it will collect by 10 pence per pound and the Senedd (Welsh Parliament) sets the Welsh rate of income tax to be added to the UK rates of tax.

2 For 2021-22, the Senedd set each Welsh rate of income tax at 10 pence, meaning that Welsh taxpayers pay an amount of tax equivalent to the UK rate for each tax band.

Source: The Welsh Government

5 The Government of Wales Act 2006, as amended by the Wales Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of HMRC's rules and procedures, in consequence of the Welsh rate provisions, to ensure 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 that is attributable to a Welsh rate resolution; and
- the accuracy and fairness of amounts reimbursed to HMRC as administrative expenses.

6 This report assesses:

- HMRC's calculation of the 2020-21 income tax revenue for Wales, the 'outturn', and assurance on the correctness of amounts brought to account (Part One);
- HMRC's estimate of the 2021-22 income tax revenue for Wales and our view on the estimate methodology (Part One);
- key controls operated by HMRC to assess and collect income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Welsh tax requirements (Part Two); and
- the cost of administering Welsh income tax. We provide assurance on the accuracy and fairness of these amounts in the context of costs incurred by HMRC (Part Three).

7 Appendix One sets out our audit evidence base.

Key findings

Welsh income tax 2020-21 final outturn and 2021-22 estimate

8 **HMRC calculated the final outturn for 2020-21 as £2,140 million, representing amounts collected under Welsh income tax policy.** HMRC's estimate of Wales's 2020-21 income tax revenue, published in November 2021, was £2,100 million, meaning the actual outturn was £39 million higher than HMRC had originally estimated. We examined the methodology for the calculation of the actual outturn, which necessarily includes remaining areas of estimation, for instance where returns from taxpayers had not yet been received. In these areas, we have evaluated the basis of HMRC's estimate, including relevant assumptions and available data. Based on that audit work, we have concluded that the Welsh income tax revenue outturn for 2020-21 is fairly stated (paragraphs 1.2 to 1.15).

9 **HMRC has estimated Welsh income tax revenue for 2021-22 as £2,356 million**. This represents an increase of £216 million (10.1%) compared with the 2020-21 outturn. Income tax for the whole of the UK increased by 13.2% in 2021-22. The increases in UK and estimated Welsh income tax revenues reflect the recovery of the economy after the acute phase of the COVID-19 pandemic had ended. HMRC expects to calculate the finalised 2021-22 income tax outturn attributable to Wales in 2023. The estimate HMRC produces is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Welsh Government (paragraphs 1.16 to 1.20).

10 **External factors have increased the level of uncertainty in HMRC's estimate of Welsh income revenue in 2021-22.** HMRC identified the key source of uncertainty as the accuracy with which it can estimate Wales's share of UK income tax liabilities, particularly since this estimate relies on survey data from 2019-20. External factors outside its direct control, such as the wave of the Omicron variant of COVID-19 that developed during the year and the impact of the Ukraine conflict on taxpayers' ability to meet their tax liabilities, have introduced further uncertainty to the estimate. We consider the approach adopted by HMRC to estimating the impact of these areas of uncertainty on Welsh income tax revenue in 2021-22 to be reasonable (paragraph 1.21).

Administration of Welsh rates of income tax

11 **HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Welsh income tax and that those rules are being complied with.** Our work on Welsh income tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. As part of that audit, we concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that these regulations and procedures are being duly carried out (paragraphs 2.2 to 2.13).

12 **Maintaining an accurate and complete record of the addresses of the residency status of Welsh taxpayers remains the key challenge in administering the system.** HMRC relies on taxpayers notifying it of a change of address, although there is no legal requirement for them to do so. We found that there had been an increase in the number of Welsh postcodes identified by HMRC's address-cleansing work as either missing or invalid, with 6% (81,716) of the overall taxpayer population identified as either missing or invalid in June 2021 compared with 4% (53,467) in September 2020. HMRC has investigated and updated those cases where individuals were either employed or receiving a pension (paragraphs 2.14 to 2.24).

13 **HMRC continues to assess the risk of non-compliance in relation to Welsh income tax as low because there is no divergence between Welsh tax rates and the rest of the UK.** In 2021-22, HMRC produced a Welsh Strategic Picture of Risk (SPR). It considers the main areas of risk to Welsh income tax to be the same as those compliance risks which are assessed at the whole-of-UK level. There are no risks identified in the Welsh SPR which are specific to Wales (paragraphs 2.25 and 2.26).

14 **HMRC calculated a compliance yield of £100 million relating to Wales for 2020-21, the most recent data available.** HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues it has generated, and the revenue losses it has prevented. HMRC also estimated that the Welsh share of net losses was £370 million. HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Welsh-specific data to quantify the risks. HMRC does not consider or report on geographical variations in the level of compliance risk, or the relative success of compliance activity in Wales compared with the rest of the UK (paragraph 2.27).

15 **HMRC has limited performance data available about its compliance activities in Wales.** Unlike its income tax system which flags residents as Welsh, HMRC's compliance system cannot readily identify people living in Wales. HMRC therefore cannot easily track and monitor compliance activity in Wales and this affects its ability to collect performance data about the extent of Welsh non-compliance (paragraph 2.29).

16 **COVID-19 continued to have an impact on HMRC's compliance activities during 2021-22.** Across the UK, the number of compliance cases opened and closed in 2021-22 was higher than in 2020-21 but 27% lower than in 2019-20 before the pandemic. The ability to conduct face-to-face enquiries and the need to re-deploy compliance staff to support other COVID-19 measures also affected its compliance activity during the year. HMRC's yield from its tax compliance activities for the whole of the UK was £30.8 billion in 2021-22, up 1.1% compared with 2020-21 but lower than the £36.9 billion reported in 2019-20. It will take some time to understand fully the impact of the pandemic on tax compliance and yield (paragraphs 2.30 and 2.31).

17 **Tax debt has reduced since 2021 but remains higher than pre-pandemic levels.** HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2022, total tax debt for the UK was £41.6 billion, 86% (£19.2 billion) higher than the level of debt reported at 31 March 2020, before the impact of the COVID-19 pandemic. HMRC expects the level of tax debt to fall more slowly than it initially anticipated. An analysis of income tax debt attributable to Wales is not currently available (paragraph 2.32).

Costs

18 **In 2021-22 HMRC incurred and recharged £0.4 million to the Welsh Government for the cost of implementing and administering Welsh income tax.** We examined HMRC's method for estimating the costs of collecting and administering Welsh income tax for the year ended 31 March 2022. Based on our audit work, we have concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government. 2021-22 is the first year since income tax powers were devolved to Wales that expenditure relates exclusively to operating costs. HMRC did not incur any costs for implementing the Welsh Income Tax Project, unlike previous financial years, because the project closed in February 2021 (paragraphs 3.4 and 3.5 and Figure 8).

Part One

Income tax collected from Welsh taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for Welsh income tax in 2020-21 and its provisional estimate of Welsh income tax revenue for 2021-22. This includes:

- our assessment of HMRC's Welsh income tax outturn calculation for 2020-21, including data limitations and HMRC's judgements in areas of uncertainty; and
- our views on HMRC's estimate of Welsh income tax revenue for 2021-22 and the features and limitations of HMRC's methodology.

The Welsh income tax 2020-21 final outturn

1.2 HMRC's calculation of the outturn for Welsh income tax revenue for 2020-21 is £2,140 million (**Figure 2** overleaf). HMRC calculates the final outturn figure from several components, which are aggregated to produce the total Welsh income tax liability for 2020-21. Each component is calculated using one or more sources of data to extract the total Welsh income tax liability. HMRC's previous estimate of 2020-21 Welsh income tax, published in November 2021, was £2,100 million, meaning the actual outturn was £39 million (1.8%) higher than HMRC had originally estimated.

1.3 The outturn calculation is largely based on established tax liabilities, some £2,177 million, where HMRC has finalised the tax owed and fully reconciled the taxpayer records. HMRC calculates the established liabilities from the final tax liability data extracted from the Pay As You Earn (PAYE) and Self Assessment income tax systems.

1.4 HMRC makes adjustments or estimates where tax due has not yet been finalised, or where HMRC must estimate the Welsh share of uncollectable amounts or tax reliefs. The reduction in Welsh income tax outturn arising from these adjustments was £57 million (net) (Figure 2). In some areas of the calculation, HMRC does not have data in sufficient detail to identify income tax liabilities, reliefs or other adjustments relating to individual taxpayers. HMRC estimated the Welsh share of these balances by using other available data, such as population and income data, to apportion the balance between Wales and the rest of the UK.

Figure 2

HM Revenue & Customs' (HMRC's) calculation of the 2020-21 Welsh income tax revenue outturn

The majority of the outturn is based on established liabilities with a small proportion estimated by HMRC

	2020-21			2019-20
	Amounts based on established taxpayer liabilities	Amounts based on estimated liabilities and adjustments	Total	Total
	(£mn)	(£mn)	(£mn)	(£mn)
Self Assessment established liabilities[1]	684	(10)	674	620
Pay As You Earn (PAYE) established liabilities[1]	1,514	(8)	1,506	1,461
Estimated further liabilities[2]	–	50	50	45
Deductions from revenue[3]	–	(90)	(90)	(85)
Total	**2,197**	**(57)**	**2,140**	**2,041**

Notes

1 Self Assessment and PAYE established tax liabilities are based primarily on the tax liability data held by HMRC, although some amounts are based on estimates as well.

2 This is HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future Self Assessment returns or compliance activity.

3 Deductions from revenue include tax relief on pension contributions and Gift Aid.

4 Numbers shown in brackets are negative numbers.

5 Totals do not sum due to rounding.

Source: HM Revenue & Customs, *Annual Report and Accounts 2021-22*, HC 494, July 2022 and National Audit Office analysis of HM Revenue & Customs data

1.5 HMRC and the Welsh Government discussed and agreed the methodology used to calculate the 2020-21 outturn for Welsh income tax at the Welsh Rates of Income Tax Board in April 2022.

1.6 We examined the methodology for the outturn calculation, which necessarily includes some remaining areas of estimation, for instance where returns from taxpayers had not yet been received. In these areas, we evaluated the basis for HMRC's estimate including relevant assumptions and available data. We concluded that the Welsh income tax revenue outturn for 2020-21 is fairly stated. We describe the key components of the calculation of outturn in more detail below.

Self Assessment established liability

1.7 The Self Assessment established liability of £674 million represents the calculation of all income tax attributable to Wales from Welsh Self Assessment taxpayers in 2020-21. The calculation of Self Assessment liabilities is mainly based on the extraction of Welsh taxpayer data from HMRC's systems but with some apportionment of other balances.

1.8 HMRC identifies Welsh taxpayers using its record of Welsh residency status in its 'Computerised Environment for Self Assessment' (CESA) system. It can identify total Welsh income tax liabilities by extracting Welsh taxpayer records from CESA. HMRC has also made minor adjustments to apportion Wales's share of other relevant Self Assessment balances where specific data are not available.[1]

PAYE established liability

1.9 The PAYE established liability of £1,506 million represents the sum of all income tax attributable to Wales from Welsh PAYE taxpayers in 2020-21. While most PAYE liabilities are based on extracting Welsh taxpayer data from HMRC's systems, some apportionment of other smaller elements is required.

1.10 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees and this information is recorded in HMRC's National Insurance & PAYE Service (NPS) system. HMRC identifies Welsh taxpayers in the NPS using a residency indicator based on taxpayer postcode information. By extracting Welsh taxpayer records from the NPS, HMRC can identify the total Welsh income tax liabilities. HMRC deducts from this the Welsh share of tax reliefs given against PAYE liabilities.

1.11 An adjustment is made to apportion the tax collected from employers under PAYE settlement agreements.[2] The Welsh share calculated for 2020-21 was £2.5 million. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded and therefore HMRC undertakes an analysis of employer submissions to determine the Welsh proportion of UK-wide settlement agreement revenue. HMRC was able to base this on a complete set of PAYE settlement agreement returns from employers for 2020-21, compared with the previous year when it did not receive all returns in line with the expected timetable due to the COVID-19 pandemic.

Estimated further liabilities

1.12 Most Self Assessment liabilities for 2020-21 are established prior to calculating the outturn. Nevertheless, HMRC knows from past years that Self Assessment tax liabilities will continue to be established and collected for up to six years afterwards. This is because HMRC continues to receive additional information from taxpayers and through its compliance activity. HMRC calculates the estimated additional liability for these elements based on past performance and valued it at £49 million in the 2020-21 outturn. HMRC made an estimated adjustment of £1.4 million in relation to further PAYE liabilities that had not yet been determined, such as where year-end totals or information about benefits-in-kind received by the taxpayer were still outstanding.

1 This includes an estimate of £4 million from manually entered liabilities and assessments, which do not provide a split of the liability between taxes. It also includes sensitive records, which are not accessed by HMRC to calculate the Welsh share of income tax. A sum of £16 million was deducted for the Welsh share of tax reliefs claimed through Self Assessment.

2 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.

Deductions from revenue

1.13 HMRC makes a series of deductions from the outturn revenue, recognising that not all taxpayer liabilities will be collected in practice. It uses historical information to calculate these deductions and apportions an amount for Welsh taxpayers.

1.14 Some PAYE and Self Assessment income tax liabilities are never settled because either employers or taxpayers fail to pay the full amounts due. HMRC has analysed historical data for all the UK to determine patterns of uncollected liabilities and then apportioned an amount relating to Welsh taxpayers. HMRC calculated this to be £23 million for 2020-21.

1.15 HMRC makes further deductions for pension contributions and Gift Aid, both of which attract income tax relief at the taxpayer's marginal rate of income tax. Pension scheme administrators claim tax relief at the basic rate from HMRC on behalf of their scheme members, while charities claim tax relief at the basic rate from HMRC on behalf of their donors. HMRC calculated both deductions by estimating the Welsh share of each tax relief claimed across the UK using historical data. HMRC calculated the Gift Aid deduction to be £29 million for 2020-21 and pension contributions to be £38 million.

The Welsh income tax estimate for 2021-22

1.16 HMRC estimates it will collect £2,356 million of Welsh income tax revenue relating to the 2021-22 year.[3] This represents an increase of £216 million (10.1%) against the 2020-21 outturn. There was a 13.2% increase for the UK overall. Income tax revenues increased in both Wales and the rest of the UK in 2021-22, reflecting the recovery of the economy after the acute phase of the pandemic had ended. The final outturn for the 2021-22 year is expected to be published in HMRC's 2022-23 Annual Report and Accounts by July 2023. The estimate produced by HMRC is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Welsh Government.

1.17 HMRC's methodology to estimate Welsh income tax revenue for 2021-22 is based on taxpayer data from 2019-20, extracted from its Survey of Personal Incomes. Wales's percentage share of the overall UK income tax liability is determined by analysing data in a model replicating the UK income tax system known as the Personal Tax Model. The data are adjusted to reflect demographic and policy changes that are expected or known to have taken place between 2019-20 and 2021-22. The share is then applied to the total UK tax liability to produce an estimate of revenue for Welsh income tax (**Figure 3**).

3 HM Revenue & Customs, *Annual Report and Accounts 2021-22*, HC 494, July 2022.

Figure 3

Method for calculating the Welsh 2021-22 income tax revenue estimate

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

Survey of Personal Incomes

HM Revenue & Customs (HMRC) collected data from a 1.5% sample of UK taxpayers in 2019-20.[1]

→

Personal Tax Model

HMRC calculated the percentage share of UK income tax that related to Welsh taxpayers to be 1.20%.

→

Adjusted Welsh share

HMRC adjusted the percentage share to reflect changes to population, earnings and tax legislation since the Survey of Personal Incomes.

This resulted in a revised Welsh share of 1.17%.

→

Total UK income tax liability 2021-22

HMRC combined Self Assessment liabilities[2] with Pay As You Earn (PAYE) receipts to calculate the total liability for the UK of £205.6 billion.[3]

→

Total Welsh income tax liability 2021-22

HMRC applied the previously calculated Welsh share to the total income tax liability. The estimate of Welsh income tax calculated was £2.4 billion.[4]

→

Calibrated 2021-22 Welsh revenue estimate

HMRC calculated an overall calibration adjustment of 1.3% to reflect that historically the actual outturn has been lower than the initially estimated amount from this methodology. The calibrated estimate is £2.4 billion.[5]

Notes

1 HMRC's annual Survey of Personal Incomes is a sample of UK taxpayers' data from the PAYE and Self Assessment tax systems. The Personal Tax Model projects the outcome for income tax liabilities in 2021-22, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Welsh share.

2 Non-savings, non-dividend income only.

3 PAYE data come from HMRC's Real-Time Information system. Self Assessment data come from HMRC's Self Assessment Model.

4 HMRC applied the previously calculated Welsh share to the total income tax liability before Gift Aid, and then removed the estimated share of Welsh Gift Aid along with other much smaller adjustments.

5 The calibration adjustment for Wales is calculated on a band-by-band basis. When compared with the outturn, the basic rate adjustment was calculated to be 0.2%, the higher rate 6.0% and the additional rate 18.2%. When looked at in totality, this resulted in a 1.3% calibration adjustment for 2021-22.

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

1.18 HMRC made a 'calibration' adjustment to the Welsh revenue estimate because its methodology has historically resulted in actual outturn being lower than estimated outturn. HMRC made this adjustment by comparing the 2020-21 outturn with a revised estimate of 2020-21 revenue using the same methodology but with the most recent assumptions and data. The impact of the calibration adjustment reduced the 2021-22 provisional estimate by £31 million (1.3%) (see Figure 3).

1.19 The calibration adjustment is subject to the following limitations:

- It assumes the 2021-22 over-estimation is consistent with the over-estimation observed in 2020-21 in percentage terms.
- The causes of the over-estimate in 2020-21 are not fully understood and any socioeconomic factors contributing to it may be different in 2021-22.

1.20 Our review concluded that HMRC's approach is reasonable. However, the limitations we described in previous reports relating to HMRC's methodology for estimating Welsh income tax revenue remain relevant for 2021-22:

- The use of sample data introduces sampling uncertainty into the revenue estimate from which the Welsh portion is calculated as a percentage.
- The methodology combines the calculation of PAYE and Self Assessment liabilities for the UK such that the amount apportioned to Wales does not reflect the differing proportions of each type of taxpayer between Wales and the rest of the UK.
- The data used for PAYE include all income types and do not exclude tax from savings and dividend income.
- An assumption must be made around the volume and value of under- and over-payments relating to PAYE liabilities.

1.21 HMRC identified the key source of uncertainty in the 2021-22 estimate as the accuracy with which it can estimate Wales's share of UK income tax liabilities. The estimated share is based on 2019-20 survey data, so there is an inherent risk that this could change for Wales by 2021-22. HMRC estimates that Welsh income tax liabilities will grow at a slower rate than the UK overall. External factors outside HMRC's direct control, such as the wave of the Omicron variant of COVID-19 that developed during the year and the impact of the Ukraine conflict on taxpayers' ability to meet their tax liabilities, increases the level of uncertainty around estimating Wales's share. We consider that HMRC has taken a reasonable approach to estimating the impact of these areas of uncertainty on Welsh income tax revenue in 2021-22.

Part Two

Administering Welsh income tax

2.1 This part of the report covers:

- HM Revenue & Customs' (HMRC's) key processes to administer the income tax system and our approach to obtaining assurance on them (paragraphs 2.5 to 2.13);
- HMRC's procedures to identify and maintain a complete and accurate record of the Welsh taxpayer population (paragraphs 2.14 to 2.24); and
- HMRC's activity to identify and respond to compliance risks (paragraphs 2.25 to 2.33).

2.2 HMRC uses the same systems to administer income tax whether it is received from a taxpayer in Wales or the rest of the UK. However, HMRC also operates additional rules and procedures for Wales, and we assess these below. This reflects HMRC's responsibility to administer income tax for Welsh taxpayers in the same way as the service provided elsewhere in the UK.

2.3 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General (C&AG) must consider the adequacy of HMRC's systems to assess and collect tax in the UK, including income tax. Each year we publish a report (the Standard Report) alongside HMRC's Annual Report and Accounts setting out the C&AG's conclusions in this respect. Our 2021-22 Standard Report concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are duly carried out.

2.4 To support the conclusions of this report, we extended our UK-wide testing to address risks and approaches arising from divergences in income tax policy. We also undertook specific procedures looking at HMRC's address-cleansing and wider tax compliance activities. These informed our assessment of the completeness and accuracy of HMRC's Welsh income tax estimates. To reach our conclusions, we examined several elements of devolved tax administration, such as the ongoing maintenance of Welsh taxpayer records, and how devolved tax compliance risks were identified and responded to.

The income tax system

2.5 HMRC's system to collect income tax is consistent across the UK. Depending on the type of income an individual receives, income tax is assessed and collected by employers deducting earnings through Pay As You Earn (PAYE), by the taxpayer submitting a Self Assessment return, or both.

2.6 The PAYE and Self Assessment processes share common principles, despite using different IT systems and data sources to assess and collect tax. **Figure 4** identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.7 Our annual audit work programme on HMRC includes procedures providing assurance over key tax processing controls. These controls are broadly divided into two categories:

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

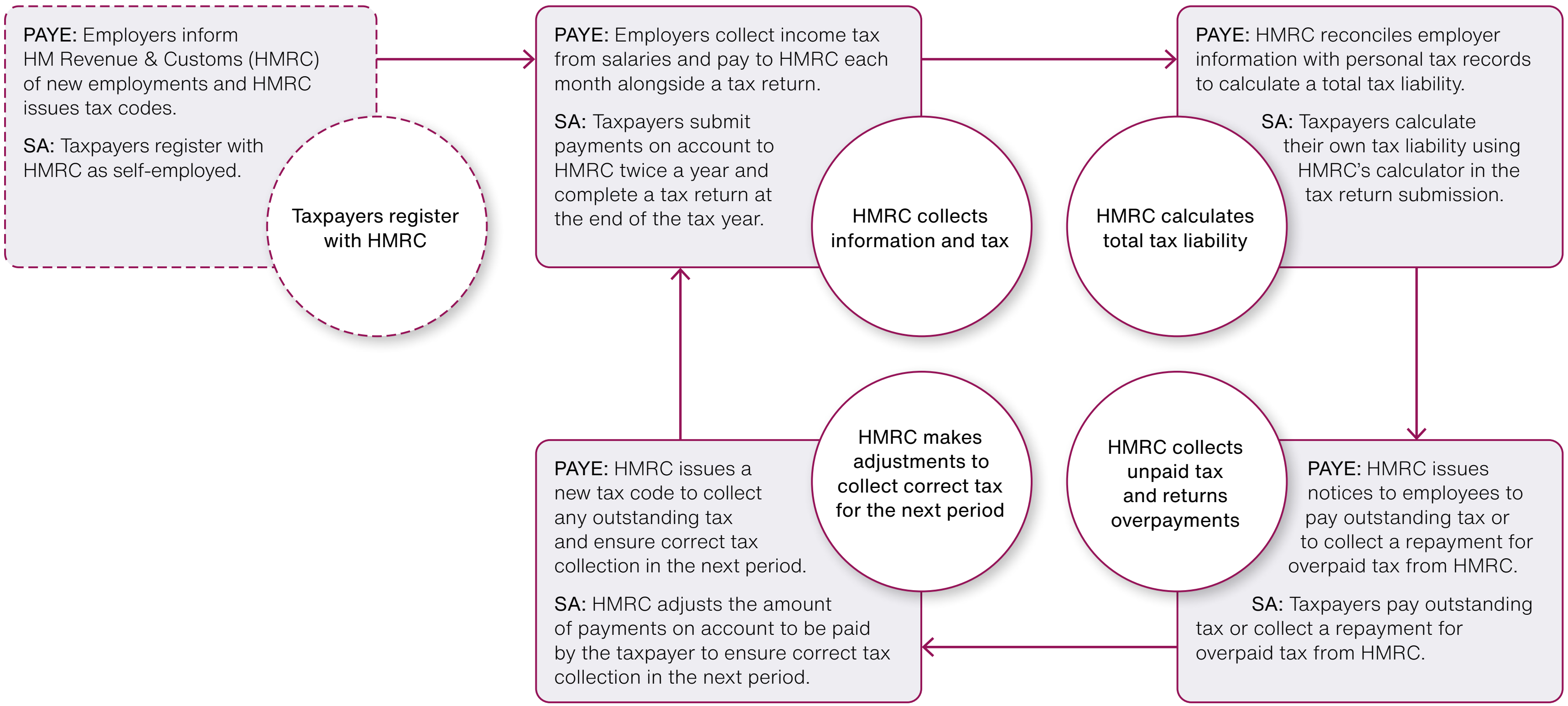
2.8 Following annual updates to business rules to reflect changing tax rates, thresholds, and allowances for the UK and devolved administrations, HMRC completes several phases of assurance testing on key business controls to confirm system functionality. We evaluate the scope of this testing and re-perform elements to confirm HMRC's conclusions as part of our audit. The key processes for PAYE include annual:

- reconciling employer information with personal tax records to confirm tax due on earnings and calculate any over- or under-payments of tax based on country of residence; and
- issuing tax codes to PAYE taxpayers which incorporate residency information to ensure employers deduct tax under the tax rules of the correct country.

2.9 Similar processes are applied to each individual Self Assessment return that HMRC receives. Self Assessment taxpayers make payments on account and at the year-end calculate their own tax liability using HMRC's calculator in the tax return submission.

Figure 4
The UK 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



Notes

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.

2 After the tax year ends, HMRC's PAYE reconciliation process calculates the income tax liability for each taxpayer using all available data. The calculated liability is compared with amounts deducted at source or collected from taxpayers directly to determine whether the correct tax has been collected.

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

Devolved income tax

2.10 The main differences in administering Welsh income tax, when compared with UK processes, are the business rules that the HMRC system applies when completing tax liability and tax code calculations. There have been no significant changes to system rules since our last report covering 2020-21. The rules applied for Welsh taxpayers are as follows:

- The system checks the individual's residency status and applies the 'C' tax code prefix where they are identified as a Welsh resident. This instructs employers to collect tax under Welsh tax rates. Where an individual is no longer resident in Wales, the 'C' prefix is removed.
- Where an individual is identified as a Welsh resident, Welsh tax rates and bands are applied to the reported income when calculating the liability for the current tax year.
- If an individual has been identified as a Welsh resident and is enrolled on a PAYE scheme, the system uses Welsh income tax rates to calculate a new tax code for the following year.

2.11 Self Assessment returns include a check box for the taxpayer to state whether they resided in Wales during the tax year. If this contradicts HMRC's records, HMRC uses the address it holds to calculate the taxpayer's tax liability. HMRC notifies taxpayers of the discrepancy and asks them to update their address if required. **Figure 5** shows where these divergences occur within the income tax system.

Tax relief on pension contributions

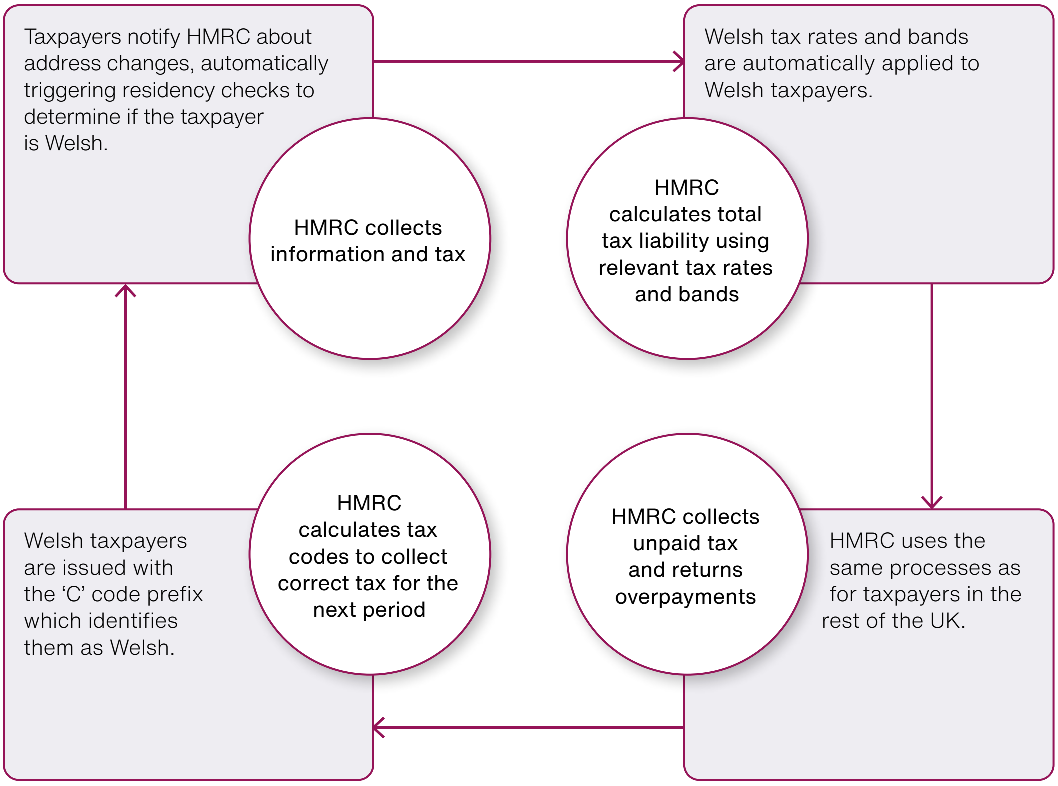
2.12 Pension scheme administrators must identify Welsh taxpayers so that tax relief is correctly allocated. Pension administrators claim tax relief at source on behalf of their members and add this to their members' contributions. HMRC's Relief at Source (RAS) system automatically confirms the residency status of pension scheme members to ensure the correct relief is applied at source. It applies tax relief on pension contributions at the basic rate of 20% for all taxpayers. Welsh taxpayers paying a tax rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

2.13 To administer relief at source, HMRC requires all pension administrators to submit an annual report listing their members' contributions during the previous tax year. HMRC's systems automatically trace scheme members and matches them against addresses held to identify Welsh taxpayers. An Annual Notification of Residency Report is then issued to all pension administrators. HMRC confirmed the residency status for 93% of Scottish and Welsh pension scheme members following the 2020-21 tax year. Following the 2020-21 tax year, HMRC issued Annual Notification of Residency Reports to pension scheme administrators in January 2022.

Figure 5

Divergences in the income tax system for Welsh taxpayers

HM Revenue & Customs' (HMRC's) 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

Welsh taxpayer population

2.14 HMRC has calculated that there were 1.4 million Welsh taxpayers in 2020-21.[4] A Welsh taxpayer is someone with a tax liability whose main place of residence during the tax year is Wales.[5] Higher-rate and additional rate taxpayers accounted for 8% of the Welsh income tax population in 2019-20 but contributed more than 40% of income tax paid. Basic rate taxpayers accounted for 92% of the population and provided almost 60% of tax paid (**Figure 6** overleaf).

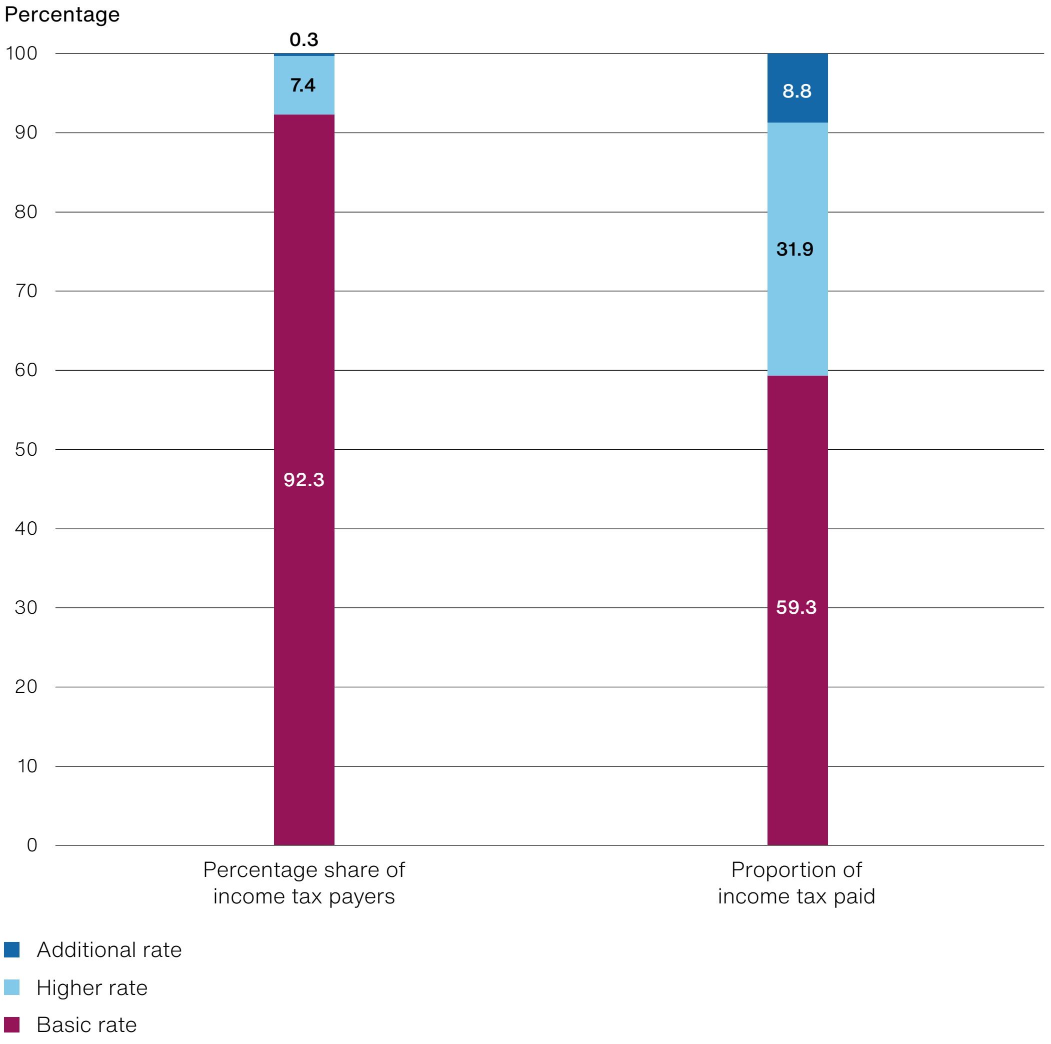
4 HM Revenue & Customs, *Welsh Income Tax Outturn Statistics: 2020 to 2021*, July 2022.

5 Welsh parliamentarians are also deemed Welsh taxpayers. See paragraph 2.24 for more details.

Figure 6

Proportions of income taxpayers by band and income tax paid by band in Wales, 2020-21

Higher-rate and additional rate income taxpayers accounted for 8% of the population but contributed more than 40% of the income tax paid



Note

1 2020-21 is the latest year for which data are available.

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

2.15 Maintaining accurate and complete records of the Welsh taxpayer population continues to be the main challenge for HMRC in administering Welsh income tax. HMRC has many information sources for changes of address but relies primarily on taxpayers informing it of such changes on a timely basis, although taxpayers are not legally required to do this. HMRC also obtains address information from other sources such as employers, although it is not mandatory for employers to provide updates when their employees' addresses change.

2.16 Address information must be correct to ensure the right amount of tax is collected from individuals and allocated to the appropriate government. HMRC has several assurance processes in place to maintain the completeness and accuracy of the address data it uses to identify Welsh taxpayers (**Figure 7** overleaf).

Postcode scans

2.17 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. It investigates and updates identified cases where individuals were either employed or receiving a pension. The most recent scan performed in June 2021 identified 81,716 postcodes either missing or invalid, of which 1,708 were updated. This compares with 53,467 postcodes either missing or invalid in HMRC's previous scan in September 2020, of which 6,343 were subsequently updated. Those cases not updated are identified as dormant because they have no current taxable income. Numbers of postcodes either missing or invalid increased over the previous year and now represent 6% of the 1.4 million Welsh income taxpayer population, compared with 4% in September 2020.

The administration of Welsh tax codes

2.18 Where an employer does not apply the 'C' prefix to an employee's tax code, they will deduct tax at the UK rate. HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid at the end of the tax year. HMRC then uses this finalised information and the residency status held on its systems to calculate the tax liability each taxpayer should pay. The outturn for Wales is, therefore, unaffected where the 'C' prefix in an individual's tax code is not correctly applied by an employer.

2.19 Each month, HMRC compares tax codes in PAYE submissions with its own taxpayer record to identify cases where employers are using a different tax code. The number of cases where the correct 'C' prefix was not being operated varies across the year. In March 2021, HMRC identified 47,818 Welsh taxpayer records (2.6% of cases) where employers were not operating a tax code with a 'C' prefix. In March 2022, there were 40,455 cases (2.1% of cases). We noted in previous reports that HMRC has not set a target for how low the number of missing 'C' prefixes would be before it considers that its compliance activity has been successful.

Figure 7

Assurance over the Welsh taxpayer population

HM Revenue & Customs (HMRC) carries out several assurance activities to maintain the completeness and accuracy of the Welsh tax base

Assurance activity	Purpose	Results
Controls ensuring Welsh residency is correctly determined using the address held by HMRC		
New postcodes	Comparison of HMRC's list of Welsh postcodes with Office for National Statistics (ONS) data to ensure postcodes are up to date.	Postcode data are received quarterly from the ONS. There were 599 new postcodes added in 2021-22.
Address cleansing	Scans of taxpayer records held by HMRC to identify missing or invalid postcodes which would result in an incorrect residency status being applied.	Scans undertaken in June 2021 identified 28,938 missing postcodes. Of these, 339 cases were updated because they had a record of current employment or pension. The remaining records were not updated because no employment was listed. HMRC also identified 52,778 invalid postcodes and updated 1,369 taxpayer records where there was a record of current employment or pension.[1]
Cross-border postcodes	HMRC's systems flag address changes where new addresses lie in a postcode that crosses the England-Wales border. HMRC reviews these cases to ensure the correct residency is determined.	This process has been in place since October 2019. In 2021-22, 461 cross-border cases were reviewed, of which 119 were amended following investigation.
Missing residency flags	Scans to identify Welsh taxpayer records that are not flagged as such in the system.	Scans undertaken during 2021-22 identified 339 cases, all of which were updated.
Controls monitoring the operation of Pay As You Earn (PAYE) by employers		
Tax code comparison scans	A comparison between tax codes in PAYE submissions with HMRC's taxpayer record to identify cases where the employer is applying a different tax code to HMRC.	In March 2022 there were 40,455 cases identified where 'C' prefixes were not correctly applied to tax codes.[2]
Controls to identify incorrect addresses held by HMRC		
Third-party data comparison	A comparison of taxpayer address records held by HMRC with third-party data sources to identify cases where HMRC records are inconsistent with third-party data.	HMRC and the Welsh Government have agreed to run this exercise every two years. The most recent one was performed in March 2021 and compared 2.8 million Welsh address records. HMRC identified 9,433 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data.
High net worth individuals	HMRC performs checks and procedures to review the movements of high net worth individuals and ensure their addresses are up to date.	

Notes

1 Invalid postcodes identified are corrected or manually set as Welsh where the correct postcode cannot be determined from the address.

2 Figures are from HMRC's analysis of monthly tax code scans and show the number of tax codes where the Welsh 'C' prefix was not correctly applied, and where the tax code would have otherwise been correct.

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

2.20 When HMRC identifies an employer is not using the correct tax code, it issues a P6 notification to the employer asking them to update the employee's tax code. HMRC identifies employers making persistent errors and works with them to implement the correct tax code. HMRC told us that the number of employers that repeatedly use the incorrect tax code is very small and so it does not routinely track this information.

Third-party data exercise

2.21 HMRC periodically compares the Welsh taxpayer address records it holds with third-party data to identify differences. This comparison is HMRC's main source of assurance over its address information and it previously agreed with the Welsh Government to run the exercise every two years.

2.22 In March 2021, 2.8 million Welsh address records held by HMRC were compared with third-party data, showing that:

- 2.2 million records (75.7% of records analysed) held by HMRC were successfully matched to third-party data with a Welsh address. This is a decrease from 80.7% in the previous third-party data exercise in 2018;
- 9,433 records (0.3% of records analysed) were identified where the residency determined from the address held by HMRC did not match the residency suggested by third-party data; and
- the residency status of taxpayers for 0.7 million records (24.1% of records analysed) could not be corroborated by comparison with the third-party data. HMRC reviewed these records against other internal data sources to gain assurance over the accuracy of the addresses held.[6]

2.23 HMRC wrote to most of the taxpayers where the details of residence held by HMRC did not match that suggested by third-party address data. Letters asked taxpayers to check that the address held by HMRC was up to date. There are limits to how effective this exercise can be. Due to data protection legislation, HMRC can only write to each taxpayer at the address it holds on its system, and not any alternative address indicated by the third-party data exercise. HMRC has not assessed the outcome of the third-party data exercise in Wales, but it has followed up a sample of 100 Scottish taxpayers who received a similar letter in 2021. It found 33 had subsequently updated their address details with HMRC. It also found 30% of all Scottish taxpayers receiving a letter had also received a letter during the previous third-party data exercise in 2019.

6 Approximately 78,000 records were discounted from any analysis as the individuals concerned were under the age of 18, deceased, indicated as living abroad or were duplicate records.

Welsh parliamentarians

2.24 Welsh parliamentarians are automatically deemed as Welsh taxpayers in any tax year they are in office. This applies to the 60 elected members of the Welsh Parliament (MSs) and the 40 members of Parliament in Westminster representing a constituency in Wales. Records for Welsh parliamentarians are not processed using normal business rules. HMRC previously used a manual process to identify these records and ensure they were recorded as Welsh taxpayers regardless of residency. HMRC required employers or parliamentarians to provide the required information to HMRC annually. HMRC introduced system changes designed to remove the need to annually update parliamentarians' records in August 2020. HMRC told us that it did not identify any issues in relation to Welsh parliamentarians being recorded as Welsh taxpayers during 2021-22.

Compliance risk assessment and planning

2.25 HMRC applies the same risk-based compliance approach to collect income tax in Wales as it does in the rest of the UK. This approach involves:

- **promoting** compliance by designing processes to encourage and help customers get things right first time;
- **preventing** non-compliance through process design and customer insight and providing an opportunity to correct mistakes; and
- **responding**, investigating and correcting compliance risks using tailored activity when intervention is needed.

2.26 As part of its Service Level Agreement with the Welsh Government, HMRC produces an annual Welsh Strategic Picture of Risk (SPR) to assess and plan for compliance risks applicable to Wales. For the Welsh SPR, HMRC considers key compliance risks at the overall UK level and applies a value to represent the Welsh proportion of these risks. HMRC does not vary the size of this proportion for each risk; instead it is calculated in line with Wales's share of UK income tax in the Welsh Income Tax Outturn Statistics. As with previous years, HMRC has not identified any significant risks specific to Wales and considers the main risks to Welsh income tax are the same as for the whole of the UK. These risks include:

- evasion, where individuals or businesses deliberately omit, conceal or misrepresent information to reduce their tax liabilities;
- the hidden economy, where taxable income is not declared or where declared income is deliberately understated; and
- tax avoidance, where tax rules are exploited to gain a tax advantage that Parliament never intended.

2.27 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield, its estimate of the additional revenues it considers it has generated and the losses it has prevented. HMRC estimates a compliance yield of £100 million in 2020-21 for Wales's share of the risks in the SPR. It also estimates that Wales's share of net losses from these risks was £370 million.[7] HMRC calculates these figures as a proportion of the equivalent UK figure, rather than using Wales-specific data to quantify the risks. HMRC does not consider or report on geographical variation between Wales and the rest of the UK when assessing compliance risk or the relative success of compliance activity.

2.28 The tax gap is the difference between the amount of tax that should be paid and what is actually paid. HMRC does not currently produce a Welsh-specific tax gap. In response to a report by the Committee of Public Accounts, HMRC noted that calculating a Welsh-specific tax gap would be difficult for methodological reasons and the high degree of uncertainty of such an analysis.[8]

2.29 HMRC has limited information on specific compliance activity undertaken in Wales. Its compliance system allows HMRC to raise a flag where potential manipulation of residency status has been identified. We understand there are currently no such flags on the compliance system. It told us that information about numbers of active compliance cases relating to Welsh taxpayers for reasons not related to their status as a Welsh taxpayer requires interrogation of separate information systems. Unlike the income tax system, which can flag Welsh residents, HMRC's compliance management information system cannot readily identify people living in Wales and information must be compared with other data to provide numbers on the extent of Welsh non-compliance in total.

Impact of COVID-19 on HMRC's compliance activity and debt management

2.30 The impact of the COVID-19 pandemic, and HMRC's response to it, affected its compliance activity in 2021-22 and reduced the level of tax receipts collected through it. The pandemic limited HMRC's ability to visit taxpayers to carry out its compliance investigations. In addition, some staff were reallocated from compliance work to support other COVID-19 measures during the year. Across the UK, the number of compliance cases opened and closed in 2021-22 was higher than in 2020-21 but 27% lower than in 2019-20 before the pandemic.

7 This relates to the latest data available for net losses, covering 2019-20. This means the impact of the COVID-19 pandemic on net losses will only begin to show in next year's SPR.

8 HM Treasury, *Treasury Minutes: Government responses to the Committee of Public Accounts on 'Tackling the tax gap, Twentieth Report of Session 2019–2021'*, January 2021.

2.31 HMRC's yield from its tax compliance activities was £30.8 billion in 2021-22, up 1.1% compared with 2020-21 but lower than the £36.9 billion reported in 2019-20. Our recent report *Managing tax compliance following the pandemic* found that HMRC's compliance work had raised around £9 billion less revenue since the pandemic began, compared with historical levels. We concluded that it would take some time to understand fully whether the pandemic has affected tax compliance, with swift action likely to be needed to prioritise efforts and stem potential losses.[9]

2.32 HMRC's management of tax debt affects how much income tax that is initially unpaid is subsequently collected across the UK, including in Wales. HMRC's debt balance is affected by external factors that have an impact on taxpayers' ability to pay their tax liabilities, including current inflationary pressures and increases in the cost of living. At 31 March 2022, total tax debt for the UK was £41.6 billion, 28% (£15.9 billion) less than the debt reported at 31 March 2021 but 86% (£19.2 billion) higher than the level of debt reported at 31 March 2020, before the impact of the pandemic. HMRC expects the level of tax debt will fall more slowly than it initially anticipated. Our report *Managing tax debt through the pandemic* provides further detail on how HMRC changed its debt management work in response to the pandemic.[10] An analysis of income tax debt attributable to Wales is not currently available.

2.33 Having completed our additional work on devolved tax issues, we are satisfied HMRC has adequate rules and procedures in place to assess and collect Welsh income tax and that these are being complied with.

9 Comptroller and Auditor General, *Managing tax compliance following the pandemic*, Session 2022-23, HC 957, National Audit Office, December 2022.

10 Comptroller and Auditor General, *Managing tax debt through the pandemic*, Session 2021-22, HC 799, National Audit Office, November 2021.

Part Three

Costs

3.1 This part considers the administrative costs of Welsh income tax and whether they are reasonable.

3.2 Under the Service Level Agreement between HM Revenue & Customs (HMRC) and the Welsh Government, the Welsh Government must reimburse HMRC for net additional costs incurred through administering Welsh income tax powers.

3.3 A supporting framework sets out the principles for identifying net additional costs. HMRC recharges the Welsh Government only for costs that specifically relate to administering devolved Welsh income tax powers, not for the costs of administering the overall income tax system in Wales.

Costs incurred in 2021-22

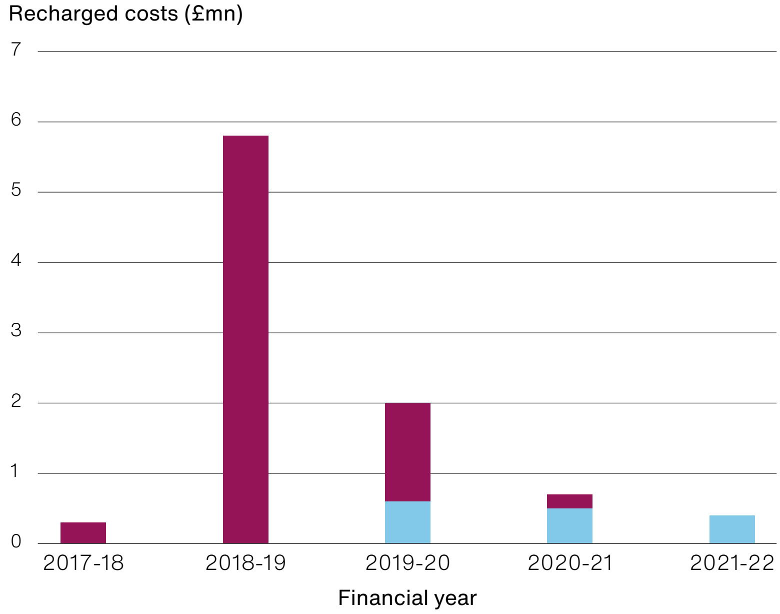
3.4 HMRC invoiced the Welsh Government for £0.4 million of costs relating to the administration of Welsh income tax in 2021-22. This was a £0.2 million underspend against the budget of £0.6 million. Reasons for the underspend against the budget included less time spent on Welsh income tax by HMRC staff than planned. There have been no significant changes to the recharging process in 2021-22. The 2021-22 costs were lower than in previous years, largely because 2021-22 is the first year since income tax powers were devolved to Wales that expenditure relates exclusively to operating costs. HMRC did not incur any costs for implementing the Welsh Income Tax Project, unlike previous financial years, since the project closed in February 2021 at a final cost of £7.9 million. In 2020-21 HMRC recharged costs of £0.7 million, comprising £0.5 million of operating costs and £0.2 million of implementation costs (**Figure 8** overleaf).

3.5 We examined HMRC's method for estimating the costs to collect and administer Welsh income tax for the year ended 31 March 2022. Based on our audit work, we concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government.

Figure 8

Actual spending on Welsh income tax projects from 2017-18 to 2021-22

2021-22 was the first year in which spending related solely to operating costs



	2017-18	2018-19	2019-20	2020-21	2021-22
Implementation costs	0.3	5.8	1.4	0.2	0
Operating costs	0	0	0.6	0.5	0.4

Notes

1 Implementation costs include the Welsh rate of income tax (WRIT) project, the annual tax summary (ATS) project and the relief at source (RAS) project.

2 The annual figures represent the audited figures at the end of each financial year. Implementation costs do not sum to the final project cost of £7.9 million due to actual costs incurred across the lifetime of the project being greater than the estimated accrued amounts for each reporting period.

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

Appendix One

Our evidence base

1 Section 80HA of the Wales 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 Welsh 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 Welsh rate resolution; and
- the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses.

2 To reach the conclusions of this report relating to the rules and procedures operated by HMRC, we drew directly from our statutory audit work on HMRC's Annual Report and Accounts, including the C&AG's report on HMRC's controls for the proper assessment, collection and allocation of tax under Section 2 of the Exchequer and Audit Departments Act 1921. We also completed specific audit procedures over controls relevant to administering devolved taxes.

Financial audit

3 We audited the data, methodologies, assumptions and mechanics of the calculation for the revenue outturn for 2020-21 and the revenue estimate for 2021-22, which are described in this report. For the estimate, and where appropriate for the outturn, this work was planned and completed by applying 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 HMRC charged to the Welsh Government is based upon evaluating costs against the details of the Service Level Agreement and supporting framework for costs agreed between both parties. HMRC estimated some of the incurred costs from available data on customer contacts and staff time. During the audit, we saw evidence that both parties regularly discuss and review cost budgets and forecasts as well as agreeing any amounts to be invoiced and paid.

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

6 We completed our financial audit fieldwork between April 2022 and July 2022.

Document review

7 To evaluate HMRC's approach to compliance risk, we reviewed published and unpublished HMRC documents about Welsh income tax including project documentation, risk and compliance documentation, and details of key assurance work performed by HMRC.

8 Our review was carried out between October 2022 and December 2022.

Interviews with departmental officials

9 We carried out four interviews with officials from HMRC, selected to participate because of their job role and their relevance to the audit. This included staff responsible for (or involved in) devolved tax policy and compliance.

10 We also spoke to the Welsh Government to inform our risk assessment and planning for this report.

11 Fieldwork took place between October 2022 and November 2022. Interviews were carried out online, typically lasted one hour and notes were taken.

Third-party data exercise teach-in

12 To inform our understanding of HMRC's processes to gain assurance over the Welsh taxpayer population we attended a teach-in run by HMRC in November 2022 covering the third-party data exercise which it performs using a third-party supplier.

Quantitative analysis

13 We analysed financial data from HMRC on Welsh income tax revenue, HMRC's estimate of Welsh income tax revenue and the administrative costs of Welsh income tax.

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