PAPLS/S5/21/4/A

The Scottish Parliament
Pàrlamaid na h-Alba

PUBLIC AUDIT AND POST-LEGISLATIVE SCRUTINY COMMITTEE

AGENDA

4th Meeting, 2021 (Session 5)

Thursday 4 February 2021

The Committee will meet at 9.30 am in a virtual meeting and broadcast on www.scottishparliament.tv.

1. **Decision on taking business in private:** The Committee will decide whether to take items 3, 4 and 5 in private.

2. **Administration of Scottish income tax 2019/20:** The Committee will take evidence from—

   Stephen Boyle, Auditor General for Scotland;

   Mark Taylor, Audit Director, Audit Scotland;

   Gareth Davies, Comptroller and Auditor General;

   Darren Stewart, Director, Financial Audit, National Audit Office.

3. **Administration of Scottish income tax 2019/20:** The Committee will consider the evidence heard at agenda item 2 and take further evidence from—

   Stephen Boyle, Auditor General for Scotland;

   Mark Taylor, Audit Director, Audit Scotland.

4. **Proposed revisions to Standing Order rules:** The Committee will consider correspondence from the Standards, Procedures and Public Appointments Committee.

5. **Key audit themes - Managing public sector ICT projects:** The Committee will consider a draft report.

PAPLS/S5/21/4/A

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The papers for this meeting are as follows—

Agenda Item 2

Note by the Clerk	PAPLS/S5/21/4/1
PRIVATE PAPER	PAPLS/S5/21/4/2 (P)

Agenda Item 4

PRIVATE PAPER	PAPLS/S5/21/4/3 (P)

Agenda Item 5

PRIVATE PAPER	PAPLS/S5/21/4/4 (P)

Public Audit and Post-legislative Scrutiny Committee

4th Meeting, 2021 (Session 5), Thursday 4 February 2021

Administration of Scottish income tax 2019/20

Introduction

1. At its meeting today, the Public Audit and Post-legislative Scrutiny Committee will take evidence from the Comptroller and Auditor General (C&AG) and the Auditor General for Scotland (AGS) on the National Audit Office report on the Administration of Scottish income tax 2019-20 and the assurance report from the Auditor General for Scotland.

Background

2. From April 2016, the Scottish Parliament set a Scottish rate of income tax and from April 2017 onwards, the total amount of non-savings, non-dividend income tax collected in Scotland is paid to the Scottish Government. HM Revenue and Customs (HMRC) collects and administers Scottish income tax. HMRC's accounts are audited by the National Audit Office (NAO).

3. The C&AG is required to report to the Scottish Parliament on HMRC's administration of Scottish income tax. His sixth report on Scottish income tax was laid in the Scottish Parliament on 22 January 2021. The report by the Comptroller & Auditor General can be found in **Annexe A.**

4. When the predecessor Public Audit Committee published its report, Framework for auditing Scottish income tax in 2014, the Committee recommended that the AGS should provide additional assurance on the NAO's audit work. The report and briefing paper from the AGS can be found in **Annexe B**.

Clerks to the Committee
1 February 2021

Annexe A

National Audit Office

Administration of Scottish income tax 2019-20

HM Revenue & Customs

REPORT

by the Comptroller and Auditor General

SESSION 2019–2021
22 JANUARY 2021
HC 1074
SG/2021/15

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Administration of Scottish income tax 2019-20

HM Revenue & Customs

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 21 January 2021

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

Gareth Davies
Comptroller and Auditor General
National Audit Office

15 January 2021

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Key facts

2.5m	**£11,556m**	**£11,703m**
Scottish taxpayers in 2018-19[1]	Scottish income tax revenue in 2018-19	HM Revenue & Custom's estimate of Scottish income tax revenue in 2019-20

£0.6 million project implementation costs in 2019-20

£0.9 million costs of administering Scottish income tax in 2019-20

£24.3 million total lifetime cost of implementing Scottish income tax projects

Note

1 Refers to Scottish taxpayers with non-savings, non-dividend income.

Summary

Introduction

1 The Scotland Act 2016 gave the Scottish Parliament full power to determine the rates and thresholds[1] (excluding the personal allowance) paid by Scottish taxpayers on all non-savings, non-dividend income from 6 April 2017. The Scottish Government receives all income tax revenue generated from non-savings, non-dividend income under Scottish income tax policy.

2 In 2018-19, the Scottish Government introduced two new income tax bands for non-savings, non-dividend income, the starter rate and intermediate rate bands. The rates for the existing higher rate and top rate income tax bands were also increased. In 2019-20, the Scottish Government chose not to increase the higher rate thresholds in line with the rest of the UK, resulting in further divergence (see **Figure 1** overleaf). The point at which taxpayers pay the higher rate in Scotland was £43,431 in 2019-20 and remained the same as in 2018-19. The threshold for the higher rate tax band for the rest of the UK increased to £50,001 (2018-19: £46,351). The personal tax allowance was £12,500 in both Scotland and the rest of the UK in 2019-20.

Roles and responsibilities

3 HM Revenue & Customs (HMRC) administers and collects 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. HM Treasury is responsible for the payment of Scottish income tax to the Scottish Government.

4 Following the end of each tax year, HMRC produces a provisional estimate of the Scottish income tax revenue for that year. The final outturn is calculated in the following year once HMRC has received further information from taxpayers and employers. This report covers the final outturn for 2018-19. The outturn for 2019-20 is due to be published by HMRC in its 2020-21 Annual Report and Accounts.

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

Figure 1

Scottish and rest of UK income tax rates and bands for 2019-20

The introduction of the Scottish starter and intermediate rates in 2018-19 means there are five tax bands in Scotland compared to three in the rest of the UK

	Scottish income tax rates		Rest of UK income tax rates	
Band	Taxable income	Tax rate	Taxable income	Tax rate
		(%)		(%)
Personal Allowance[1]	Up to £12,500	0	Up to £12,500	0
Starter rate	£12,501 to £14,549	19	–	–
Basic rate	£14,500 to £24,944	20	£12,501 to £50,000	20
Intermediate rate	£24,945 to £43,430	21	–	–
Higher rate	£43,431 to £150,000	41	£50,001 to £150,000	40
Top rate[2]	over £150,000	46	over £150,000	45

Notes

1 A taxpayer's Personal Allowance is reduced by £1 for every £2 of net income above £100,000.

2 This is known as the Additional Rate in the rest of the UK.

Source: HM Revenue & Customs, *Income Tax rates and Personal Allowances*, www.gov.uk/income-tax-rates/previous-tax-years, accessed November 2020 and HM Revenue & Customs, *Income Tax in Scotland*, www.gov.uk/scottish-income-tax/2019-to-2020-tax-year, accessed November 2020

Remit of the Comptroller and Auditor General

5 Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014 and the Scotland Act 2016, 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.

6 This report considers:

- HMRC's calculation of the 2018-19 income tax revenue attributable to Scotland, the 'outturn', and provides assurance on the correctness of the amounts brought to account (Part One);
- HMRC's estimate of the 2019-20 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 income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements (Part Two); and
- the cost of administering Scottish income tax – we provide 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 and recommendations

Scottish income tax 2018-19 final outturn and 2019-20 estimate

7 **HMRC calculated the final outturn for 2018-19 as £11,556 million, representing amounts collected under Scottish income tax policy.** HMRC's estimate of 2018-19 Scottish income tax revenue, published in July 2019, was £11,660 million. We examined the methodology for the calculation of the actual 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 that audit work, we have concluded that the Scottish income tax revenue outturn for 2018-19 is fairly stated (paragraphs 1.2 to 1.19).

8 **HMRC has estimated Scottish income tax revenue for 2019-20 as £11,703 million.** The methodology used by HMRC to produce the 2019-20 provisional estimate is largely consistent with the prior year. For 2019-20, the calculation includes a reduction of £25 million to reflect HMRC's estimate of the economic impact of COVID-19 on taxpayer finances, which could result in amounts due to HMRC not being recovered. HMRC expects to calculate the finalised 2019-20 income tax revenue attributable to Scotland in 2021 (paragraphs 1.20 to 1.27).

9 **The impact of COVID-19 on future outturns for 2019-20 and 2020-21 is yet to be determined.** Tax receipts across the UK have fallen since the onset of the pandemic. HMRC's compliance and debt collection activities have also reduced as a result of the impact of COVID-19 on the Department's capacity, measures taken to allow taxpayers more flexibility in making payments and the ability to physically engage with businesses and individuals. HMRC will need to consider whether further refinements to the calculation of future outturns and estimates are necessary, as more data become available, to better reflect the uncertainties caused by COVID-19 (paragraphs 1.28 to 1.29).

Administration of Scottish income tax

10 **HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Scottish income tax and that those rules are being complied with.** Our work on devolved tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. 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 (paragraphs 2.6 to 2.15).

11 **Maintaining an accurate and complete record of the addresses of Scottish taxpayers to correctly determine residency 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. In November 2019, HMRC undertook a data comparison between its address records for Scottish taxpayers and third-party data to provide assurance over the accuracy and completeness of the address information it holds. Matching records could not be identified for 21.2% of Scottish taxpayers (1.1 million records) and the residency of these taxpayers could not be corroborated by comparison to third-party data. HMRC reviewed these records against other internal data sources to gain assurance over the accuracy of the addresses held. After the exercise was completed, HMRC wrote to 8,600 Scottish taxpayers (0.2% of records matched to third-party data) where its records did not match third-party data asking them to confirm their address. HMRC sent each letter to the address it held in its records, rather than that suggested by the third-party, for data-protection reasons. No other direct form of communication was undertaken with the taxpayers in question to confirm residency (paragraphs 2.16 to 2.31).

12 **HMRC continues to assess the risk of non-compliance in relation to Scottish income tax as low, although there is increasing divergence between Scottish income tax rates and the rest of the United Kingdom.** In 2019-20, HMRC produced a Scottish Strategic Picture of Risk (SPR). HMRC considers the main areas of risk to Scottish income tax to be the same as those compliance risks which are tackled at the whole-of-UK level. There are no risks identified in the Scotland SPR specific to Scotland. HMRC continues to assess the risk of a Scottish taxpayer manipulating their address to minimise their tax liability to be low. HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage. Behavioural analysis may become increasingly important to support HMRC's assessment of compliance risk if tax rates and bands continue to diverge (paragraphs 2.32 to 2.39).

13 **HMRC calculated a compliance yield of £210 million relating to Scotland for 2017-18, the most recent data available.** HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues that HMRC considers it has generated, and the revenue losses it has prevented. These figures are calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks. HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Scotland compared with the rest of the UK (paragraph 2.34).

14 **The Committee of Public Accounts (the Committee) recommended that HMRC should consider the benefits and challenges of estimating a Scotland-specific tax gap,** the difference between the amount of tax that should be paid and what is actually paid. This would be a useful measure to understand how successful HMRC is in administering Scottish income tax. HMRC is due to respond to the Committee's recommendation by January 2021 (paragraph 2.35).

Costs

15 **In 2019-20 HMRC incurred and recharged £1.5 million of costs to the Scottish Government for the cost of administering Scottish income tax.** We examined HMRC's method for estimating the costs of collecting and administering Scottish income tax for the year ended 31 March 2020. Based on our audit work, we have concluded that the amount paid by the Scottish Government was accurate and fair in the context of the agreement between HMRC and the Scottish Government. (paragraphs 3.4 to 3.6).

Recommendations

a **HMRC should consider how it reflects the impact of COVID-19 in its calculation of the revenue outturn and estimate for future years,** including consideration of what additional data might be available to refine the calculation and better reflect the uncertainties caused by the pandemic.

b **HMRC should review, by March 2022, how it can enhance the effectiveness of its third-party data comparison exercise in providing assurance over the accuracy of its address records,** and in doing so should consider:

- what additional action can be taken to reduce the proportion of records that cannot be matched to third-party data and the most appropriate time in the data-matching cycle to do so; and
- whether there are additional ways HMRC can communicate with taxpayers to confirm an address where its records do not match third-party sources, including the possibility of the use of email or communication via employers.

Part One

Income tax collected from Scottish taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for Scottish income tax in 2018-19 and its provisional estimate of Scottish income tax revenue for 2019-20. This includes:

- our assessment of HMRC's calculation of Scottish income tax outturn for 2018-19, including the data limitations and judgements applied by HMRC in areas of uncertainty within the calculation (paragraphs 1.2 to 1.19); and
- our views on HMRC's estimate of Scottish income tax revenue for 2019-20 and the features and limitations of HMRC's methodology (paragraphs 1.20 to 1.27).

The Scottish income tax 2018-19 final outturn

1.2 HMRC's calculation of the outturn for Scottish income tax revenue for 2018-19 is £11,556 million (**Figure 2** overleaf). HMRC calculates the final outturn figure from several components, which are added together to produce the total Scottish income tax liability for 2018-19. Each component is calculated using one or more sources of data to extract the total Scottish income tax liability.

1.3 The outturn calculation is largely based on established tax liabilities, some £11,598 million, where the tax owed has been finalised by HMRC and the taxpayer records have been fully reconciled.[2] The established liabilities are calculated from the final tax liability data extracted from the Pay As You Earn (PAYE) and Self Assessment income tax systems.

1.4 Adjustments or estimates are made where the tax due has not yet been finalised, or where HMRC must estimate the Scottish share of uncollectable amounts or tax reliefs. The reduction in Scottish income tax outturn arising from these adjustments was £42 million (net) (Figure 2). In some areas of the calculation, data are not available in sufficient detail to identify the income tax liabilities, reliefs or other adjustments relating to individual taxpayers. The Scottish share of these balances is estimated by apportioning the amount between Scotland and the rest of the UK using other available data, such as population and income data.

2 See Figure 6 for details of HMRC's reconciliations process.

Figure 2
HM Revenue & Customs' (HMRC's) calculation of the 2018-19 Scottish income tax revenue outturn

The table below sets out the key components of HMRC's calculation of Scottish income tax revenue outturn for 2018-19

	Amounts based on established taxpayer liabilities	Amounts based on estimated liabilities and adjustments	Total
	(£m)	(£m)	(£m)
Self Assessment established liability[1]	5,019	(65)	4,954
PAYE established liability[1]	6,579	8	6,587
Estimated further liabilities[2]		366	366
Deductions from revenue[3]		(350)	(350)
Total	**11,598**	**(42)**	**11,556**

Notes

1 Self Assessment and Pay As You Earn (PAYE) established tax liabilities are based primarily on the tax liability data held by HMRC, although some amounts are based are 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 Totals do not sum due to rounding.

Source: HM Revenue & Customs, *Annual Report and Accounts 2019-20*, HC 891, November 2020, HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2018 to 2019*, September 2020 and National Audit Office analysis of HM Revenue & Customs data

1.5 We have examined the methodology for the outturn calculation, 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 Scottish income tax revenue outturn for 2018-19 is fairly stated. The key components of the calculation of outturn are described in more detail below.

Self Assessment established liability

1.6 The Self Assessment established liability of £5,019 million represents the calculation of all income tax attributable to Scotland from Scottish Self Assessment taxpayers in 2018-19. The calculation of Self Assessment liabilities is mainly based on the extraction of Scottish taxpayer data from HMRC's systems but with some apportionment of other balances as shown in Figure 2.

1.7 Scottish taxpayers are identified by a 'Scottish indicator' flag in HMRC's 'Computerised Environment for Self Assessment' (CESA) system. By extracting Scottish taxpayer records from CESA, HMRC can identify the total Scottish income tax liabilities. Minor adjustments have also been made to apportion Scotland's share of other relevant Self Assessment balances where specific data are not available, including:

- an estimate of £43 million from manually entered liabilities and assessments,[3] which do not provide a split of the liability between taxes, as well as sensitive records, which are not accessed by HMRC to calculate Scottish income tax; and
- an estimate of £108 million deducted for the Scottish share of tax reliefs claimed through Self Assessment.

PAYE established liability

1.8 The PAYE established liability of £6,587 million represents the sum of all income tax attributable to Scotland from Scottish PAYE taxpayers in 2018-19. While most PAYE liabilities are based on extraction of Scottish taxpayer data from HMRC's systems, some apportionment of other smaller elements is required as detailed in Figure 2 above.

1.9 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. Scottish taxpayers are identified in NPS by a residency indicator based on taxpayer postcode information. By extracting Scottish taxpayer records from NPS, HMRC can identify the total Scottish income tax liabilities. HMRC deducts an estimate of the Scottish share of tax reliefs given against PAYE liabilities.

1.10 A further adjustment is made to apportion the tax collected from employers under PAYE settlement agreements. 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 administration burden of compliance for employers. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded. By analysing the employers' submissions, HMRC determined the Scottish proportion of taxpayers for each employer and allocated settlement agreement revenue according to the Scottish share. The Scottish share calculated for 2018-19 was £33 million.

3 Liabilities are manually entered onto HMRC systems in some cases where charges are raised following compliance activity, such as following missing Self Assessment returns.

1.11 Due to the impact of COVID-19, PAYE settlement agreement returns from employers were not all received in line with the expected timetable in 2020. At the point of calculating the outturn 84% of expected returns had been received. Where returns were outstanding HMRC estimated the amount of revenue for 2018-19 based on historical trends and the expected number of PAYE settlement agreements.

Estimated further liabilities

1.12 Most Self Assessment liabilities for 2018-19 are established prior to calculation of 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, as it receives additional information from taxpayers and as a result of its compliance activity. The estimated additional liability of these elements is calculated based on past performance and is reflected in the 2018-19 outturn (**Figure 3**).

1.13 The majority of taxpayer records for 2018-19 have been reconciled on HMRC's PAYE system, and the tax liabilities finalised, by the time the outturn is calculated. HMRC includes an estimate of the tax due to Scotland from records where the tax liabilities have not yet been finalised, such as where year-end totals or information about benefits-in-kind received by the taxpayer is still outstanding. The estimate is based on information received from employers detailing the amount of tax deducted at source through taxpayers' PAYE tax codes.

Figure 3

Estimated further Scottish tax liabilities relevant to 2019-20 outturn

HM Revenue & Customs' (HMRC's) estimate of further liabilities for taxpayers that will be established up to six years later based on new information received by HMRC and compliance activity undertaken

	£ million
Further Self Assessment liabilities[1]	232
Self Assessment settlement agreements[2]	98
Liabilities from PAYE unreconciled cases[3]	36
Total	**366**

Notes

1 HMRC estimates the tax it expects to collect through Self Assessment, as it receives additional information from taxpayers.

2 An estimate is included for the amount of tax expected to be collected through Self Assessment compliance activities relating to 2018-19.

3 HMRC includes an estimate of the tax due to Scotland from records where the Pay As You Earn (PAYE) tax liability has not yet been finalised.

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

Deductions from revenue

1.14 HMRC makes deductions from the outturn, recognising that not all taxpayer liabilities will be collected in practice, see **Figure 4** below. HMRC uses historical information to calculate this deduction and apportions an amount for Scottish taxpayers.

1.15 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 the whole of the UK to determine the pattern of uncollected liabilities and then apportioned an amount relating to Scottish taxpayers.

1.16 Further deductions are made 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 Scottish share of each tax relief claimed across the UK using historical data.

Figure 4
Deductions from Scottish income tax outturn for 2019-20

HM Revenue & Customs' (HMRC's) estimate of deductions from revenue outturn, recognising that not all taxpayer liabilities will be collected in practice

	£ million
Adjustment for uncollectable amounts[1]	89
Pension relief at source[2]	156
Gift Aid[3]	105
Total	**350**

Notes

1 Some Pay As You Earn (PAYE) and Self Assessment income tax liabilities are never settled because either employers or taxpayers fail to pay the full amounts due to HMRC. The estimated Scottish share of debts not expected to be collected is deducted.

2 Pension contributions attract income tax relief. The estimated Scottish share of the relief claimed by pension scheme administrators is deducted.

3 Gift Aid relief is available on charitable donations and reduces the tax liability. The estimated Scottish share of relief claimed by charities is deducted.

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

1.17 Most of the 2018-19 Scottish income tax outturn (97%) relates to established amounts (see Figure 2). The vast majority of these amounts had already been collected by HMRC by the end of March 2020.[4] In preparing its 2019-20 Annual Report and Accounts, HMRC assessed the potential impact of COVID-19 on collection rates across all taxes using various sources of projected economic data, such as the estimated number of insolvencies that may arise as a result of the pandemic.[5] As part of this work, HMRC estimated that up to £7 million of Scottish revenues relating to 2018-19 may now not be collected as a result of COVID-19. HMRC has not reduced its calculation of the 2018-19 Scottish income tax outturn by this amount due to the low values involved and inherent uncertainty in this estimate.

Agreement with the Scottish Government

1.18 The complete and accurate calculation of Scottish income tax revenue outturn is a core part of HMRC's role in devolved taxes administration. The methodology for doing so is agreed annually with the Scottish Government and HMRC publishes a summary of this in its publication *Scottish Income Tax Outturn Statistics: 2018 to 2019*.[6] We do not audit this publication.

1.19 The methodology used to calculate the 2018-19 outturn for Scottish income tax was discussed by HMRC and the Scottish Government representatives at the Scottish Income Tax Board in April 2020 and formal agreement was received from the Scottish Government in June 2020.

The Scottish income tax estimate for 2019-20

1.20 HMRC has estimated it will collect £11,703 million of Scottish income tax revenue relating to the 2019-20 year.[7] The final outturn for the 2019-20 year will be calculated in May 2021 and is expected to be published in HMRC's 2020-21 Annual Report and Accounts.

HMRC's revenue estimate for 2019-20

1.21 HMRC's methodology for estimating Scottish income tax revenue for 2019-20 is based on taxpayer data from 2017-18, extracted from its Survey of Personal Incomes. Scotland's percentage share of the overall UK income tax liability is determined through analysis of the 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 2017-18 and 2019-20. The share is then applied to the total UK tax liability to produce an estimate of revenue for Scottish income tax (**Figure 5**).

4 Income tax paid through PAYE for 2018-19 was due from employers by 22 April 2019. Income tax paid through Self Assessment for 2018-19 was due by the Self Assessment deadline of 31 January 2020.
5 HM Revenue & Customs, *Annual Report and Accounts 2019-20*, HC 891, November 2020, page 194.
6 HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2018 to 2019*, September 2020.
7 HM Revenue & Customs, *Annual Report and Accounts 2019-20*, HC 891, November 2020.

Figure 5

Method for calculating the Scottish 2019-20 income tax 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 2017-18.[1]

→

Personal Tax Model

HMRC calculated the percentage share of UK income tax that related to Scottish taxpayers to be 6.67%.

→

Adjusted Scottish 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 Scottish share of 6.90%.

→

Total UK income tax liability 2019-20

HMRC combined Self Assessment liabilities[2] with PAYE receipts to calculate the total liability[3] for the UK of £175.3 billion.

→

UK income tax liability after COVID-19 adjustment

HMRC reduced the total UK income liability by £356 million to reflect its estimate of the amount of income tax due at 31 March 2020 which may become uncollectable due to COVID-19.[4]

→

Total Scottish income tax liability 2019-20

HMRC applied the previously calculated Scottish share to the total income tax liability after adjustment for COVID-19. The estimate of Scottish income tax calculated was £12 billion.

→

Calibrated 2019-20 Scottish Revenue Estimate

HMRC calculated a calibration adjustment of 2.3% to reflect that historically the actual outturn has been lower than the initially estimated amount from this methodology. The calibrated estimate is £11.7 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 2019-20, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Scottish share.

2 Non-savings, non-dividend income only.

3 Pay As You Earn (PAYE) data comes from HMRC's Real-Time Information system. Self-Assessment data comes from HMRC's Self-Assessment Model.

4 The impact of the COVID-19 adjustment to reduce the Scottish share of income tax was £25 million.

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

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1.22 The revenue estimate is calibrated to adjust for the fact that the methodology has historically resulted in actual outturn being lower than the estimated amount. The calibration adjustment was calculated through comparison of the 2018-19 outturn with a revised estimate of 2018-19 revenue using the same methodology and with the most recent assumptions and data. The impact of the calibration adjustment on the 2019-20 provisional estimate was a reduction of £0.3 billion (2.3%) (see Figure 5).

1.23 The calibration adjustment is subject to the following limitations:

- It assumes that the 2019-20 over-estimation would be consistent with the over-estimation observed in 2018-19 in percentage terms.
- The causes of the over-estimate in 2018-19 are not fully understood and any socioeconomic factors contributing to it may be different in 2019-20.

1.24 Our review concluded that HMRC's approach is reasonable; however, the limitations that we have described in previous reports in relation to HMRC's methodology for estimating Scottish income tax revenue remain relevant for 2019-20:

- The use of sample data introduces sampling uncertainty into the estimate of revenue from which the Scottish 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 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 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.

1.25 HMRC's previous estimate of 2018-19 Scottish income tax, published in July 2019, was £11,660 million. This was based on a model using data from its Survey of Personal Incomes from 2016-17, after adjustment for historical overestimation as outlined above. The 2018-19 outturn of £11,556 million calculated in 2020 is £104 million (0.9%) lower than the estimated amount.

1.26 The current methodology for estimating Scottish income tax revenue is consistent with the methodology used by the Office for Budget Responsibility (OBR) to forecast income tax receipts for both Scotland and at the whole-of-UK level. The methodology is largely consistent with that used to calculate the 2018-19 estimate, with an additional adjustment made to reduce the estimate by £25 million to reflect the potential impact of COVID-19 on the collectability of tax revenues outstanding at the end of 2019-20.

1.27 HMRC assessed the potential impact of COVID-19 on collection rates across all taxes using various sources of projected economic data, for instance, the estimated number of insolvencies that may arise as a result of COVID-19. The Scottish share of the overall UK income tax liability figure was then applied to determine the amount relevant to Scotland. The methodology for the adjustment is subject to the following limitations:

- It is based on an estimate of the overall impact on tax receipts, with a further estimate of the proportion relating to income tax.
- It assumes that the impact of COVID-19 on the collectability of income tax is the same across the whole of the UK and does not account for any potential geographical variations.
- The assumptions used in the estimate rely on forecasts of future economic conditions, for instance in respect of insolvency rates, which are inherently uncertain.

The impact of COVID-19 on the revenue outturn and estimate

1.28 The COVID-19 pandemic is having a significant impact on the economy and, therefore, on receipts from taxes, as well as the collection of those receipts. The scale of the impact of COVID-19 is yet to be determined, but the following factors are likely to affect future outturns and estimates of Scottish income tax:

- Across the UK, from April to June 2020, tax receipts from income tax and National Insurance Contributions were at a lower level compared with the same period in 2019, although receipts in July 2020 and August 2020 slightly exceeded those in July 2019 and August 2019. The Scottish Fiscal Commission has said that it expects a significant decline in Scottish income tax revenue as a result of the pandemic.[8]
- HMRC reduced the number of new compliance cases it started. Across the UK, in April and May 2020, HMRC opened around one-third of the number of compliance cases that it opened at the same time in 2019. With many of its staff working from home, restrictions on travel and social distancing have affected HMRC's ability to visit customers and other staff have been reallocated to support the COVID-19 measures.
- HMRC also reduced its debt collection activity and following the onset of the pandemic did not undertake proactive campaigns with businesses and taxpayers to collect their tax debts, although some debt collection activities have now restarted, focusing on those customers least affected by COVID-19.

1.29 HMRC will need to consider whether further refinements to the calculation of future outturns and estimates are necessary, as more data become available, to better reflect the uncertainties caused by COVID-19.

8 Scottish Fiscal Commission, Fiscal Update, September 2020, page 14.

Part Two

Administering Scottish income tax

2.1 This part of the report covers:

- HM Revenue & Customs' (HMRC's) key processes in administering the income tax system and our approach to obtaining assurance on them (paragraphs 2.6 to 2.15);
- procedures used to identify and maintain a complete and accurate record of the Scottish taxpayer population (paragraphs 2.16 to 2.31); and
- activity undertaken by HMRC to identify and respond to compliance risks (paragraphs 2.32 to 2.39).

2.2 The administration of income tax by HMRC utilises the same systems whether tax is received from a Scottish taxpayer or a taxpayer resident in the rest of the UK. HMRC operates some additional rules and procedures that are Scotland-specific and we assess these in more detail below. This reflects HMRC's responsibility to administer income tax for Scottish taxpayers in a manner equivalent to the service provided elsewhere in the UK.[9]

2.3 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. Each year we publish a report ('the Standard Report'), alongside HMRC's Annual Report and Accounts, which sets out our conclusions in this respect.[10] Our 2019-20 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 being duly carried out.

2.4 To support the conclusions of the report, our UK-wide testing is extended to address the specific divergences caused by devolution. We also undertake specific procedures looking at HMRC's address-cleansing and wider tax compliance activities to inform our assessment of the completeness and accuracy of HMRC's Scottish income tax estimates.

9 HM Revenue & Customs, *Service level agreement for operation of Scottish Income Tax by HMRC*, September 2020.
10 Report by the Comptroller and Auditor General on HM Revenue & Customs 2019-20 Accounts.

2.5 Having completed this 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. In reaching our conclusions on these rules and procedures, we have also examined several other elements of devolved tax administration, including the ongoing maintenance of Scottish taxpayer records and the identification and response to devolved tax compliance risks.

The income tax system

2.6 HMRC's system for collecting income tax 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 6** overleaf identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.8 Our annual programme of audit work on 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.

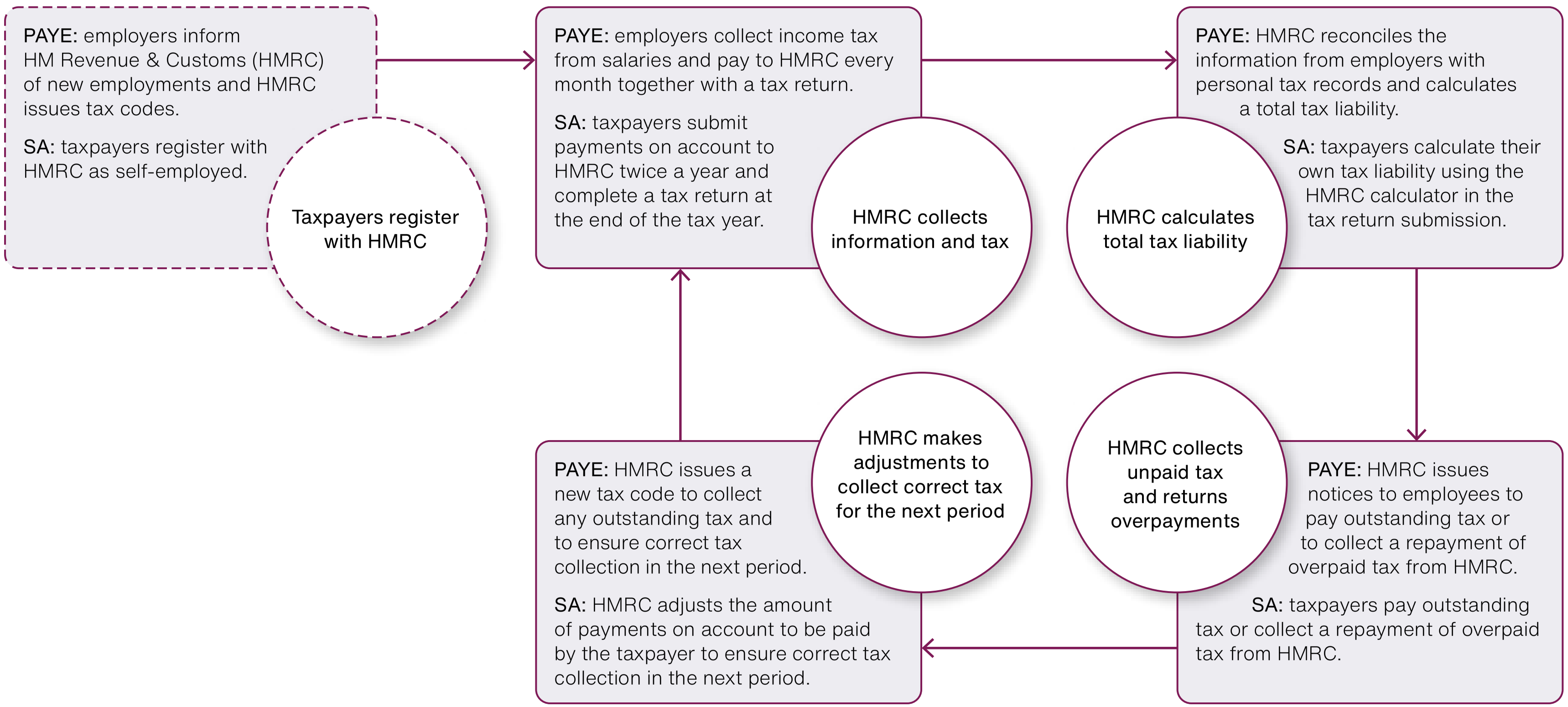
2.9 HMRC completes several phases of assurance testing on key business controls to confirm system functionality following the annual updates to business rules that reflect changing tax rates, thresholds and allowances for the UK and the devolved administrations. As part of our audit we evaluate the scope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

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

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

Figure 6
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 amount of tax has been collected.

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

Devolved income tax

2.11 The only differences in the administration of devolved taxes, when compared to the UK processes, are the business rules that the system applies when completing the tax liability and tax code calculations. There have been no significant changes to the rules since our last report covering 2018-19. The rules for Scottish taxpayers are as follows:

- The system checks the residency status of the individual and where an individual has been identified as a Scottish resident applies the 'S' tax code prefix. This instructs employers to collect tax under the Scottish tax rates. Where an individual is no longer resident in Scotland the 'S' prefix is removed.
- Where an individual has been identified as a Scottish resident, the Scottish 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 Scottish resident 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.

2.12 Self Assessment returns include a check box for the taxpayer to state whether they were resident in Scotland or Wales. Where a taxpayer's completion of the tick box contradicts HMRC records, HMRC uses the address held in its records to calculate the taxpayer's tax liability. Taxpayers are notified of the discrepancy and asked to update their address if required.

Figure 7 overleaf shows where these divergences occur within the income tax system.

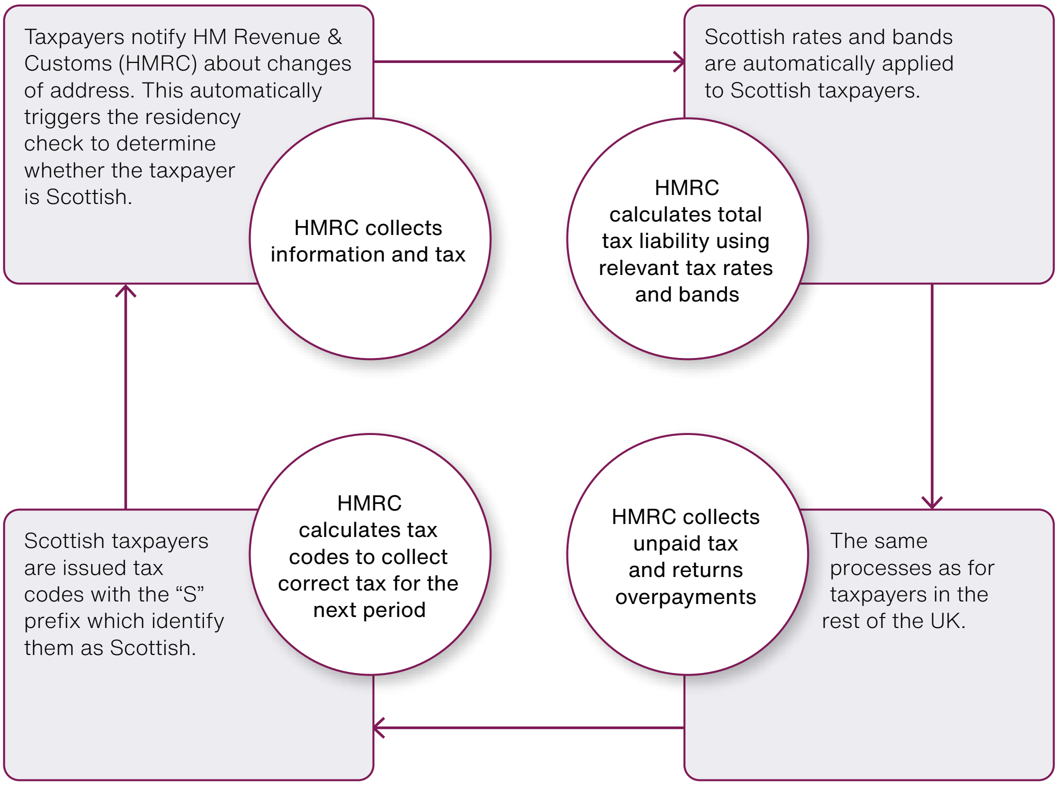
Tax relief on pension contributions

2.13 It is important that Scottish taxpayers are identified within each pension scheme so that tax relief is allocated correctly. Pension administrators claim tax relief at source on behalf of their members and add this to the contributions made. The Relief at Source project (RAS) undertaken by HMRC introduces automatic confirmation of the residency status of pension scheme members to ensure the correct relief at source is applied by pension schemes. Under the RAS project, tax relief on pension contributions continues to be applied at the basic rate of 20% for all taxpayers. Scottish taxpayers who pay tax at a rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

2.14 To administer relief at source, HMRC requires that all providers submit an annual report, listing all member contributions in the previous tax year. HMRC's systems automatically trace scheme members and match them against the addresses held to identify Scottish taxpayers. An Annual Notification of Residency Report is then issued to pension providers. HMRC told us that it had confirmed the residency status of 92% of Scottish scheme members following the 2018-19 tax year and notified pension providers of the residency status of their members in January 2020.

Figure 7
Divergences in the income tax system for Scottish taxpayers

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

Tax relief on Gift Aid contributions

2.15 Tax relief on Gift Aid contributions in Scotland is given at the UK basic rate of 20%. This is because HMRC does not have systems in place to establish the residency status of taxpayers donating to charity. All taxpayers who pay tax above the basic rate can claim the difference between their rate of tax and the basic rate on their donation.[11] Where donations are made by Scottish taxpayers the correct rate of relief is given when HMRC are notified of the amount donated.

11 This can be done through a taxpayer's Self Assessment tax return, or by asking HMRC to amend their tax code.

Scottish taxpayer population

2.16 A Scottish taxpayer is someone with a tax liability whose main place of residence during the tax year is Scotland. Scottish parliamentarians are also deemed to be Scottish taxpayers. Maintaining accurate and complete records of the Scottish taxpayer population continues to be the main challenge for HMRC in administering Scottish income tax. HMRC has calculated the number of Scottish taxpayers to be 2.5 million.[12]

2.17 HMRC has many sources of information on changes of address. HMRC relies primarily on taxpayers informing it of any address changes on a timely basis, although taxpayers are not legally required to do so. HMRC also obtains some address information from other sources, such as employers. However, it is not a mandatory requirement for employers to provide updates when employee addresses change and, therefore, HMRC is unable to assess the accuracy and completeness of this information.

2.18 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 address data used to identify Scottish taxpayers (**Figure 8** overleaf).

Postcode scans

2.19 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. This was last performed in July 2019. The corresponding exercise was due to be undertaken in July 2020 but was delayed as a result of COVID-19 resourcing pressures on HMRC. HMRC is in the process of undertaking this work, with the intention that addresses will be corrected prior to the annual tax code exercise in early 2021. If the scans are not completed before tax codes are issued to employers, there is a risk that the tax codes will not correctly identify taxpayers as Scottish. We will evaluate and report on this process as part of our 2020-21 work.

The administration of Scottish tax codes

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

12 HM Revenue & Customs, *Scottish Income Tax Outturn Statistics: 2018 to 2019*, September 2020.

Figure 8

Assurance over the Scottish taxpayer population

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

Assurance activity	Purpose	Results
Controls ensuring Scottish residency is correctly determined using the address held by HMRC:		
New postcodes	Comparison of HMRC's list of Scottish postcodes with data from the Office for National Statistics (ONS) ensures HMRC's list is kept up-to-date.	Postcode data are received quarterly from the ONS. There were 1,289 new postcodes added in 2019-20.
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.	The scans undertaken in July 2019 identified a total of 13,708 missing postcodes.[1] Of these, 1,391 cases were updated because they had a record of current employment. The remaining records were not updated because no employment was listed. HMRC also identified and reviewed 7,224 taxpayer records that had an invalid postcode.
Cross-border postcodes	HMRC's systems flag address changes where the new address lies in a postcode that crosses the England-Scotland border. HMRC reviews these cases to ensure the correct residency status is determined.	This process has been in place since October 2019. In 2019-20, nine cross-border cases were manually reviewed under this process.
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.	The number of cases where 'S' prefixes were not applied to tax codes varied, although numbers have declined during the year. In June 2019 there were 67,569 cases identified and this fell to 31,236 in April 2020.[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.	In November 2019, the addresses held by HMRC for 5.2 million Scottish taxpayers were compared with third-party data. Of these, 4.1 million (78.7%) were matched to third-party data with a Scottish address. A further 1.1 million records (21.3%) could not be matched to third-party data and HMRC compared these against other internal data on its systems.
High net worth individuals	HMRC also performs additional procedures to review the movements of high net worth individuals, to ensure that addresses are up to date and accurate.	

Notes

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

2 Amounts are from HM Revenue & Customs' analysis of monthly tax code scans and show the number of tax codes where the Scottish 'S' prefix was not being correctly applied, and the tax code would have been otherwise correct.

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

2.21 The operation of a tax code without the 'S' prefix could result in Scottish taxpayers either under- or over-paying tax during the tax year. In this situation taxpayers may have to make additional payments in future years to offset an underpayment or await a refund from HMRC for any amounts overpaid. HMRC does not collate the number of reconciliations for Scottish tax-payers where the amount of tax collected did not equal the tax HMRC calculated should have been paid.

2.22 Each month HMRC compares tax codes in PAYE submissions with its own taxpayer record to identify cases where the employer is operating a different tax code to HMRC. The number of cases where the 'S' prefix was not being operated varied across the year. In June 2019, HMRC identified 67,569 Scottish taxpayer records (2.0% of cases) where employers were not operating a tax code with an 'S' prefix. In April 2020, there were 31,236 cases (1.0% of cases). When HMRC identifies that an employer is not operating the correct tax code it issues a P6 notification asking the employer to update an employee's tax code.

2.23 HMRC's analysis found that 22% of the cases identified in April 2020, related to taxpayers whose tax code had also been incorrectly applied in June 2019. HMRC is undertaking work to target those employers who make persistent errors and work with them to implement the correct tax code. HMRC has not set a target of how low the number of missing 'S' prefixes would have to be before it could say that it had been successful in its compliance activity.

Third-party data comparison exercise

2.24 HMRC periodically undertakes a third-party data comparison exercise to compare the address records it holds to third-party sources. In October 2020, HMRC agreed with the Scottish Government that the data comparison exercise will be undertaken every two years, with the next one scheduled to be in 2020-21. The exercise is HMRC's main source of assurance over the accuracy of its address records and that taxpayers are keeping their address up to date.

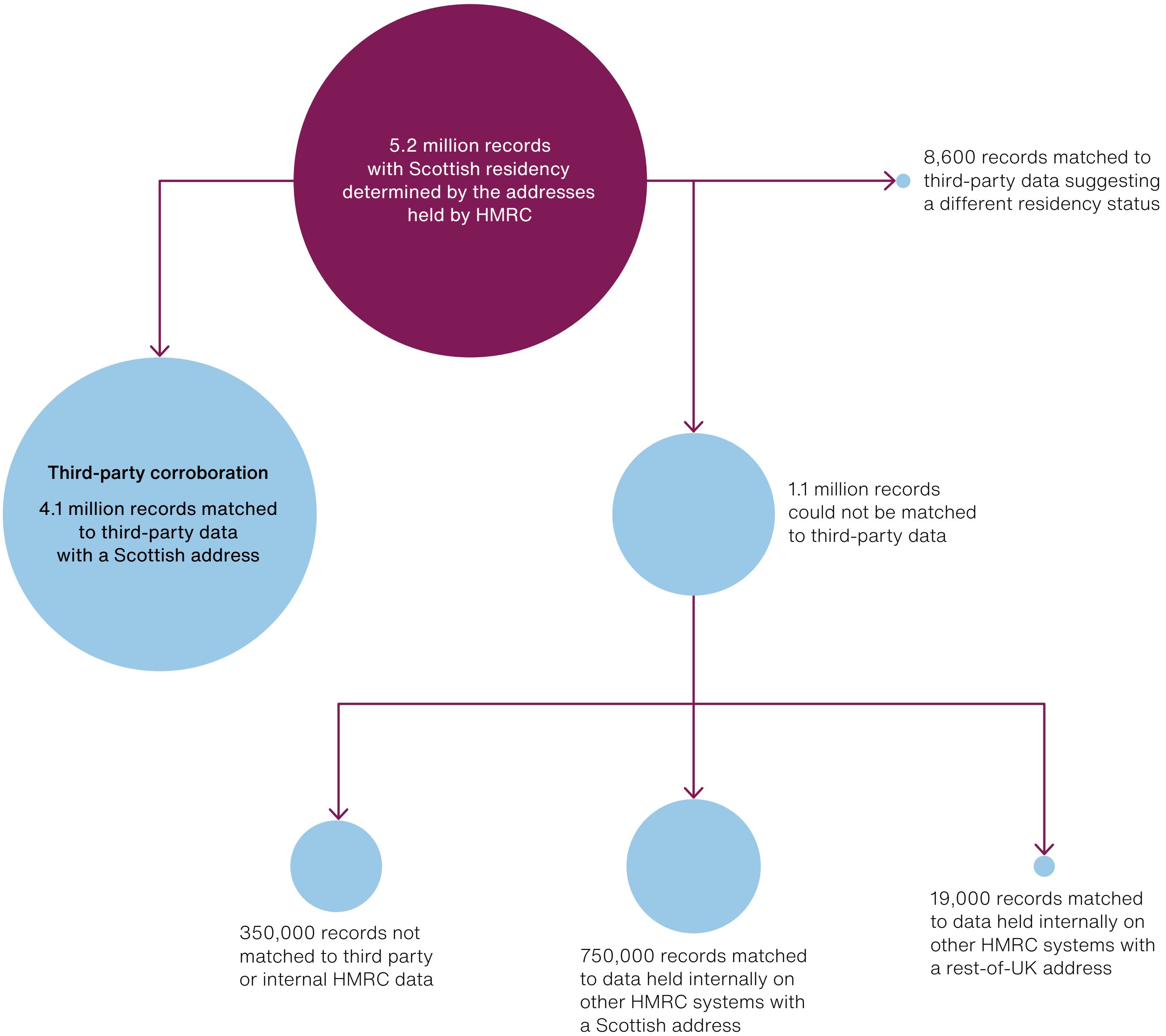
2.25 In November 2019, the records held by HMRC for 5.2 million Scottish tax-payers were compared with third-party data with the following results (**Figure 9** overleaf):

- 4.1 million records (78.8% of records) held by HMRC were successfully matched to third-party data with a Scottish address.
- 8,600 records (0.2% of records matched to third-party data) were identified where the residency determined from the address held by HMRC did not match the residency suggested by third-party data.
- The residency status of taxpayers for 1.1 million records (21.2% of records) 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.

Figure 9

Summary of taxpayer data verification exercise

HM Revenue & Customs (HMRC) has corroborated its records of taxpayer addresses to other sources of internal HMRC data where records could not be matched to third-party data



Notes

1 Of the 8,600 incorrect records identified; 4,000 were records with a Scottish address held by HMRC which were matched to third-party data with a rest-of-UK address. 4,600 were records with a rest-of-UK address held by HMRC where third-party data suggested a Scottish address.

2 Figures presented may not sum due to rounding.

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

MENU

2.26 The third-party data sources HMRC compares its records against include credit reference agencies and the electoral roll. HMRC has not considered whether other sources of information could be used to provide additional assurance where records could not be matched to third-party data as part of the initial exercise and should consider doing so in future.

2.27 HMRC sent a letter to each taxpayer 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. HMRC sent each letter to the address it held in its records, rather than that suggested by the third-party, for data-protection reasons. No other form of communication was undertaken with the taxpayers in question to confirm residency. HMRC should investigate other ways it can communicate with taxpayers where it identifies a discrepancy in address information, such as working with employers or using email addresses where this information is already held.

2.28 For the remaining 1.1 million records where it was not possible to corroborate HMRC records with those held by third parties, HMRC compared the address it held with Self Assessment data or Real Time Information (RTI) provided by employers. Of these records, HMRC successfully matched 750,000 records back to either Self Assessment or RTI data. However, 19,000 records were found to have an address in the rest of the UK. HMRC did not undertake any further action to investigate whether the correct address was held within its records.

2.29 A total of 350,000 records were unable to be matched to either third-party data or Self Assessment or RTI data. HMRC undertook further analysis of these records and identified that the vast majority were held under temporary reference numbers. It is not known how many of those records relate to Scottish taxpayers in a current employment and which could therefore affect the Scottish outturn. HMRC considers that these accounts are likely to no longer be active, as temporary reference numbers are used prior to records being created with the correct National Insurance numbers for those taxpayers.

Scottish parliamentarians

2.30 Scottish parliamentarians are automatically deemed to be Scottish taxpayers in any tax year during which they are in office.[13] This applies to the 129 elected members of the Scottish Parliament (MSPs), along with 59 members of Parliament in Westminster representing a constituency in Scotland and the seven members of the European Parliament who represented Scotland prior to the UK's exit from the EU.[14]

13 The Scotland Act 2012.
14 European Parliament website, www.europarl.europa.eu

2.31 Records relating to Scottish parliamentarians are not processed using normal business rules. HMRC has a manual process in place to identify the records of Scottish parliamentarians and ensure that they are recorded as Scottish taxpayers regardless of their residency. This requires communication of required information to them by employers or from parliamentarians themselves and must be completed annually. System changes designed to remove the need to annually update parliamentarians' records were introduced in August 2020 and their effectiveness will be reviewed in our 2020-21 report.

Compliance risk assessment and planning

2.32 HMRC applies a risk-based compliance approach to the collection of Scottish income tax in the same way as is applied to the collection of income tax from taxpayers in the rest of the UK. HMRC's approach to tackling taxpayer non-compliance involves:

- promoting compliance with tax law by designing it into systems and processes, such as by making it easier for taxpayers to pay tax;
- preventing non-compliance before it occurs by using available data to spot mistakes, personalise services and support, block fraudulent claims and automate calculations; and
- responding by identifying and targeting the areas where there may be tax at risk.[15]

2.33 The Service Level Agreement between HMRC and the Scottish Government states that a Scottish Strategic Picture of Risk (SPR) should be produced annually to consider compliance risk applicable to Scotland. The Scottish SPR was updated by HMRC in September 2020 following the calculation of the Scottish income tax outturn and shared with the Scottish Government at that time. There are no risks identified in the Scottish SPR specific to Scotland. HMRC considers the main areas of risk to Scottish income tax to be the same as those compliance risks which are tackled at the whole-of-UK level. Scotland's exposure to these risks is assumed to be in line with Scotland's share of UK income tax. The risks identified include:[16]

- registered individuals or businesses deliberately omitting, concealing or misrepresenting information in order to reduce their tax liabilities;
- the hidden economy, where an entire source of income is not declared or where a declared source of income is deliberately understated; and
- individuals undertaking tax avoidance, exploiting the tax rules to gain a tax advantage that Parliament never intended.

15 HM Revenue & Customs, *Tackling tax avoidance, evasion, and other forms of non-compliance*, March 2019.
16 HM Revenue & Customs, *Measuring tax gaps 2020 edition*, July 2020.

2.34 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues that HMRC considers it has generated, and the revenue losses it has prevented. In relation to the risks identified in the SPR, HMRC calculated a compliance yield of £210 million relating to Scotland for 2017-18, the most recent data available. HMRC also calculated the Scottish share of net losses from the risks identified in the SPR to be £990 million. These figures are calculated based on a proportion of the UK figure, rather than using Scottish-specific data to quantify the risks. HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Scotland compared with the rest of the UK.

2.35 The tax gap is the difference between the amount of tax that should be paid and what is actually paid. The Committee of Public Accounts (the Committee) recommended that HMRC should consider the benefits and challenges of estimating a Scottish-specific tax gap.[17] This would be a useful measure to understand how successful HMRC is in administering Scottish Income Tax. HMRC's response to the Committee's recommendation is expected in January 2021.

2.36 In 2019-20, the Scottish and rest-of-UK tax regimes diverged further (**Figure 10** overleaf). The increased divergence gives rise to a potential risk that taxpayers who should be subject to Scottish rates could manipulate their residency status to reduce their tax liability. This could include failure to notify HMRC of a change of address or the deliberate manipulation of address information. HMRC considers the risk of these behaviours taking place to be very low compared with the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether.

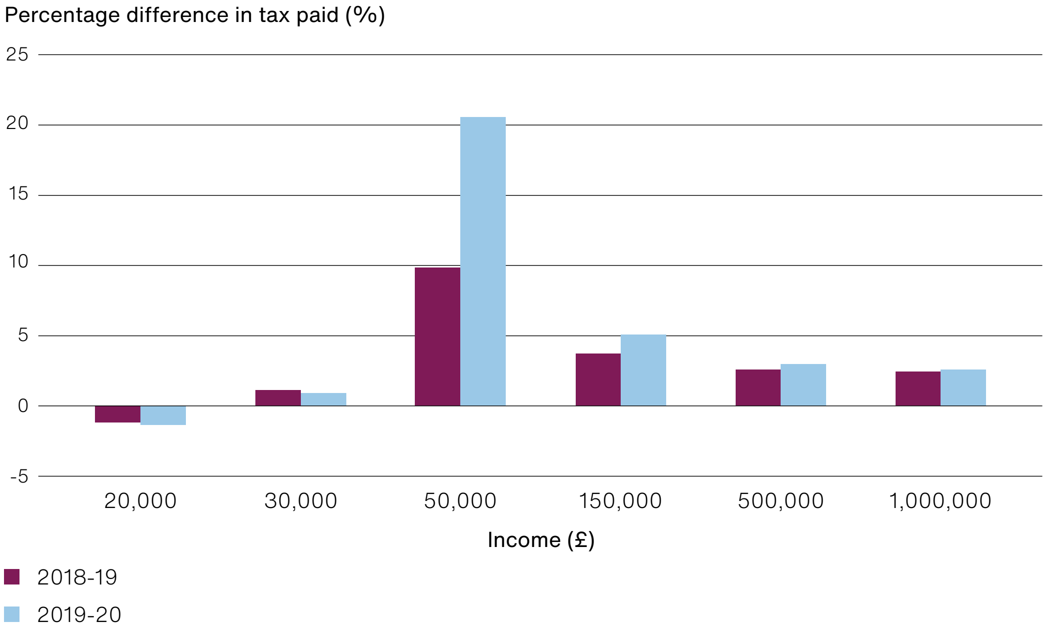
2.37 HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage. As noted above, HMRC monitors the accuracy of its address records by corroborating its data with third-party data sources. If the number of discrepancies increased this may indicate that taxpayers are not keeping their address details up to date with HMRC, either through error or deliberate non-compliance.

17 House of Commons Committee of Public Accounts, *Tackling the tax gap*, Twentieth Report of Session 2019–2021, HC 650, October 2020.

Figure 10

Differences in the tax liability between a Scottish taxpayer and a rest-of-UK taxpayer

The difference in tax liability for Scottish taxpayers earning around £50,000 has increased between 2018-19 and 2019-20



2019-20					2018-19
Income	UK income tax	Scottish income tax	Difference compared to UK income tax	Difference compared to UK income tax	Difference between Scottish and UK income tax in 2018-19
(£)	(£)	(£)	(£)	(%)	(%)
20,000	1,500	1,480	-20	-1.4	-1.2
30,000	3,500	3,530	30	0.9	1.1
50,000	7,500	9,044	1,544	20.6	9.9
150,000	52,500	55,169	2,669	5.1	3.7
500,000	210,000	216,169	6,169	2.9	2.6
1,000,000	435,000	446,169	11,169	2.6	2.4

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 rates and bands in Scotland and the UK for 2018-19 and 2019-20

2.38 HMRC said in its annual report on Scottish income tax that it monitors cross-border migration trends. Work so far has been limited, relying mainly on HMRC's core address assurance work, such as postcode scans. HMRC has stated that it will seek to use settled enquiries into Scottish taxpayers to identify any behavioural issues that impact on Scottish income tax. HMRC told us that it has set up a project to look into both Scottish and Welsh taxpayer liabilities and behaviour over time and is in discussions with the Scottish and Welsh governments about what data might be useful to do this. Behavioural analysis will become increasingly important to support HMRC's assessment of compliance risk if tax rates and bands continue to diverge. We will review these activities as part of our next report on Scottish income tax.

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

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 The 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 2019-20

3.4 HMRC invoiced the Scottish Government for £1.5 million of costs relating to the implementation and administration of Scottish income tax. Of this amount, £0.9 million related to running costs and £0.6 million related to the implementation of systems required to administer the Relief at Source project and system adjustments to include Scottish tax bands in the annual tax summary.

3.5 We examined HMRC's method for estimating the costs of collecting and administering Scottish income tax for the year ended 31 March 2020. Based on our audit work, we have concluded that the amount paid by the Scottish Government was accurate and fair in the context of the agreement between HMRC and the Scottish Government.

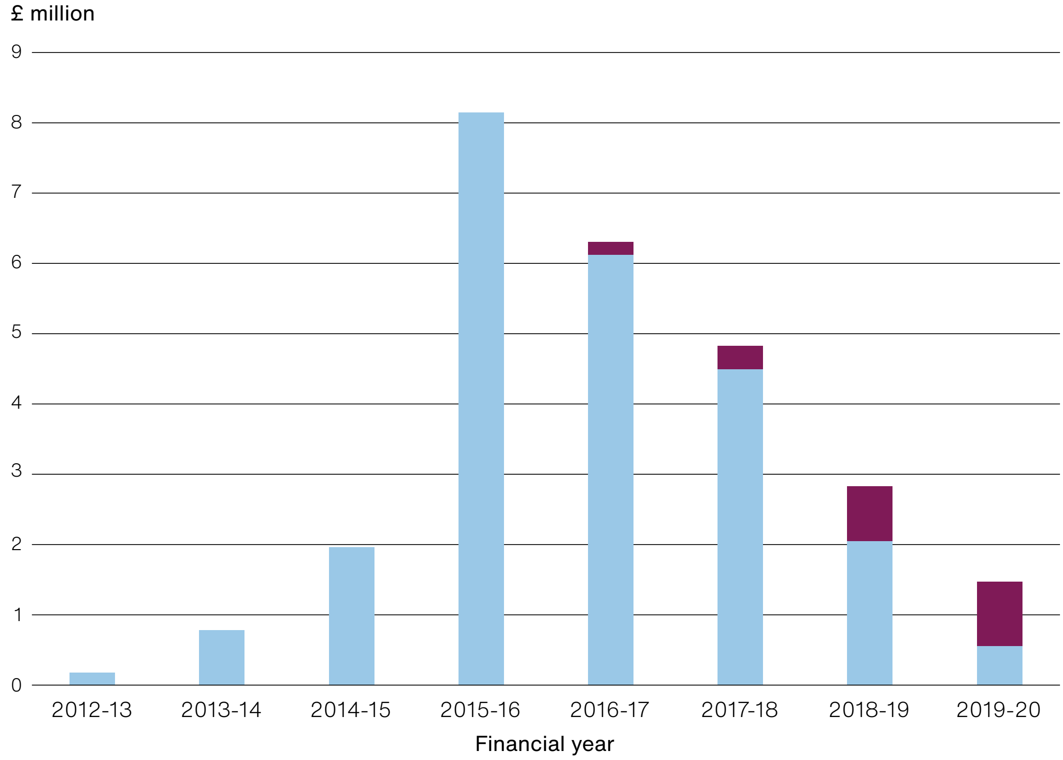
Total cost of implementing Scottish income tax projects

3.6 HMRC has now completed its work to set up the systems needed to administer Scottish income tax. Between 2012-13 and 2019-20 HMRC spent £24.3 million on implementing the systems required. **Figure 11** provides a summary of the total cost of implementing Scottish income tax projects. HMRC initially expected the total cost to be a maximum of £35 million, although the budget has fallen gradually since we published our first report in 2014-15. HMRC explained that this was due to increasing precision about costs as work progressed, rather than the work reducing in scope.[18]

Figure 11

Actual spending on Scottish income tax projects from 2012-13 to 2019-20

The final year of project implementation was 2019-20. Future spending is expected to relate solely to operating costs incurred through the ongoing administration of Scottish income tax



	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Operating costs	0.0	0.0	0.0	0.0	0.2	0.4	0.8	0.9
Implementation costs	0.2	0.8	1.7	8.4	6.1	4.5	2.0	0.6

Notes

1 Costs are for the Scottish rate of income tax project, further Scottish Income Tax Powers project, Annual Tax Summary project and the Relief at Source project.

2 Costs relating to the Relief at Source systems are apportioned between the Scottish Government and the Welsh Government.

3 Figures may not sum due to rounding.

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

18 Comptroller and Auditor General, *The administration of the Scottish rate of Income Tax 2016-17*, HC 620, National Audit Office, November 2017.

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 the revenue outturn for 2018-19 and the revenue estimate for 2019-20, which are described in this report. For the estimate, and where appropriate for the outturn, 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 Scottish income tax, including project documentation, risk and compliance documentation and the details of key assurance work being performed by HMRC.

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 November 2020.

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Annexe B

REPORT BY THE AUDITOR GENERAL FOR SCOTLAND

ADMINISTRATION OF SCOTTISH INCOME TAX 2019/20

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1. The Scotland Act 2012 introduced new powers for the Scottish Parliament from April 2016 to apply a Scottish Rate of Income Tax to the non-savings, non-dividend (NSND) income of Scottish taxpayers. The Scotland Act 2016 extended the Scottish Parliament's power to vary all income tax rates and thresholds, but not the power to determine reliefs or exemptions including the personal allowance. From 2017/18 onwards, the total amount of NSND income tax collected by HMRC in Scotland is paid to the Scottish Government.

2. HM Revenue and Customs (HMRC) collects and administers Scottish income tax and is responsible for developing its systems to implement decisions taken by the Scottish Parliament on rates and bands. The Scottish Government is responsible for funding this, ensuring that the cost of the Scottish income tax represents value for money and seeking assurances that the new system collects the correct amount of tax

3. HMRC's accounts are audited by the National Audit Office (NAO). The Comptroller and Auditor General is required under statute to report to the Scottish Parliament on HMRC's administration of Scottish income tax. He made his sixth annual report on this to the Scottish Parliament on 22 January 2021. His report relates to 2019/20 and covered the final outturn calculation of Scottish income tax for the 2018/19 tax year.

4. The Public Audit Committee's report Framework for auditing the Scottish rate of income tax set out what audit information the Scottish Parliament can expect to receive to enable it to undertake its accountability role in relation to Scottish income tax.[1] In relation to Audit Scotland, the Committee recommended that:

    - Audit Scotland provides additional assurance on the NAO's audit of HMRC and Scottish income tax. The Committee also recommended that Audit Scotland works with the NAO on its future priorities for any performance audit work on the Scottish income tax.

[1] Public Audit Committee, 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax

- the joint working relationship between the Comptroller and Auditor General and the Auditor General for Scotland should be set out in a memorandum of understanding.
- Audit Scotland reports annually on its assurance work in relation to Scottish income tax.

5. I provided my sixth annual report, providing additional assurance on the NAO's audit work on Scottish income tax on 22 January 2021. On the basis of Audit Scotland's review, I am satisfied that the NAO's approach was reasonable and that its audit work covered the key audit risks. I am also satisfied that the findings and conclusions in the Comptroller and Auditor General's report are reasonably based.

6. Audit Scotland's review was carried out in accordance with the memorandum of understanding agreed between myself and the Comptroller and Auditor General. This describes our respective powers and responsibilities and sets out a framework for collaborative working. The scope of the review is set out in paragraphs 11 to 12 of my report.

7. My report also considers the impact of tax outturns on the Scottish Government's budget. The difference between actual UK and Scottish tax outturns for 2018/19 and the amounts forecasted at the time is adjusted through the 2021/22 budget. This is known as a budget reconciliation. The reconciliation for the 2018/19 outturns results in a reduction to the 2021/22 budget of £309 million.

Annexe B

Administration of Scottish income tax 2019/20

AUDITOR GENERAL

Prepared by Audit Scotland
January 2021

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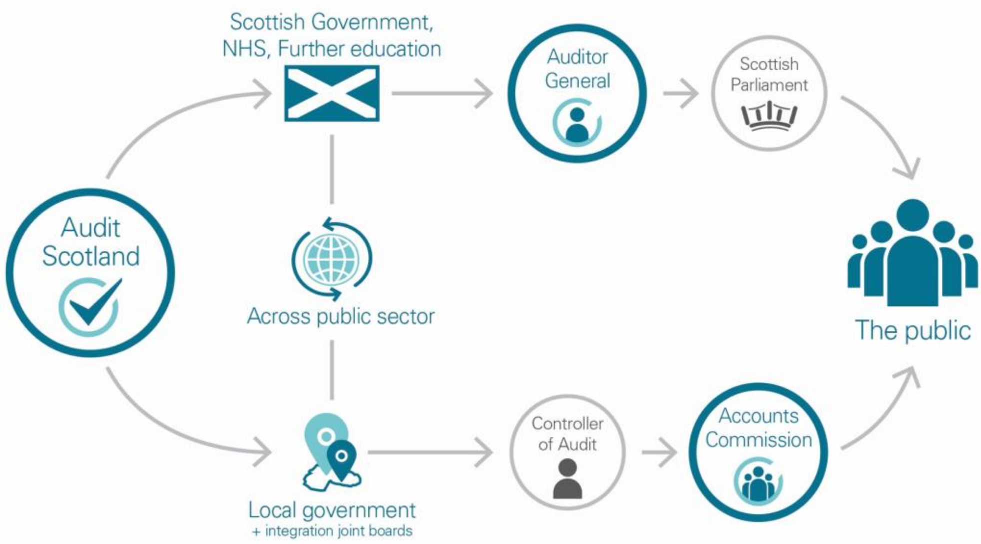
Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.

- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

Contents

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Introduction

1. The Scotland Act 2016 extended the Scottish Parliament's power to vary all income tax rates and thresholds to the non-savings, non-dividend (NSND) income of Scottish taxpayers. The power to determine any reliefs or exemptions, including the personal allowance, remains with the UK Government. From 2017/18 onwards, the total amount of NSND income tax, now referred to as Scottish income tax, collected by HM Revenue and Customs (HMRC) in Scotland is paid to the Scottish Government.

2. In 2018/19, two new Scottish income tax bands were introduced:

- The starter rate (19 per cent) and the intermediate rate (21 per cent) either side of the basic rate (20 per cent).
- The higher and additional rates of tax were also increased by one per cent for Scottish taxpayers; increasing from 40 per cent and 45 per cent to 41 per cent and 46 per cent respectively.

The higher rate threshold for the rest of the UK rose to £46,350, whereas for Scotland the higher rate threshold was set at £43,431.

3. Total Scottish income tax revenues rose by 5.9 per cent between 2017/18 and 2018/19 compared to an increase of 4.2 per cent in NSND income tax revenues across the rest of the UK.[1]

4. HMRC collects and administers Scottish income tax as part of the UK's overall income tax system. This includes separately identifying the amounts that relate to Scottish taxpayers. The Scottish Government is responsible for:

- reimbursing HMRC for the cost of implementing Scottish income tax
- ensuring that the cost of implementing Scottish income tax represents value for money
- seeking assurances that the system collects the correct amount of tax.

5. The amount of Scottish income tax collected each year is identified separately in HMRC's annual accounts. HMRC's annual accounts for 2019/20 were published in November 2020. This report relates to 2019/20, including the final outturn calculation of Scottish income tax for the 2018/19 tax year.

6. The National Audit Office's 2019/20 report gives assurance over 2018/19 outturns. This period is wholly before the Covid-19 pandemic took place. No adjustment for Covid-19 has been made to the outturn for the 2018/19 financial year.

7. The report also covers the estimated outturn for 2019/20. While Scottish income tax revenues for 2019/20 will be affected by the pandemic, albeit only for the final weeks of the financial year, these estimates do not affect the Scottish budget. The current estimated impairment to the 2019/20 estimate is £25 million. The impact of Covid-19 on Scottish income tax is likely to feature more prominently in future years.

[1] Scottish Income Tax Outturn Statistics: 2018 to 2019, HM Revenue & Customs, September 2020.

Audit and assurance

8. HMRC's accounts are audited by the National Audit Office (NAO) and received an unqualified auditor's report from the Comptroller and Auditor General (C&AG). The C&AG is also required to report to the Scottish Parliament on HMRC's administration of Scottish income tax by 31 January of the financial year after the one to which the report relates.[2]

9. In 2014, the predecessor Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on Scottish income tax.[3] I make this report to the Public Audit and Post-Legislative Scrutiny Committee in response to that recommendation.

10. Audit Scotland's review was limited to consideration of the NAO's audit work; it did not directly review evidence obtained from HMRC or discuss any matters relating to Scottish income tax directly with HMRC. The judgements and conclusions set out in the report of the C&AG are his alone, based on the audit work undertaken by the NAO on his behalf.

11. The C&AG made his sixth annual report to the Scottish Parliament on 22 January 2021. His report relates to 2019/20 and considers:

- HMRC's calculation of the 2018/19 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2019/20 income tax revenue attributable to Scotland and his view on the methodology used to estimate the amount
- key controls operated by HMRC to assess and collect Scottish income tax
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements
- 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.

12. Audit Scotland considered:

- the NAO's approach to identifying the key risks to the successful administration of Scottish income tax
- the NAO's audit working files, with focus on the audit evidence underpinning the key findings and conclusions in its report
- the NAO's arrangements for ensuring the quality of the audit work and reporting.

13. Based on Audit Scotland's review, I am satisfied that the NAO's approach was reasonable and that its audit work covered the key audit risks. I am also satisfied that the findings and conclusions in the C&AG's report are reasonably based.

[2] Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.
[3] 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax, Public Audit Committee, 2014.

Correctness of the sums brought to account

14. HMRC's 2019/20 Annual Report and Accounts included Scottish income tax outturn figures relating to the 2018/19 year. Scottish income tax in 2018/19 was £11.556 billion.[4]

15. For the 2019/20 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £11.703 billion. HMRC will publish the final Scottish income tax outturn for 2019/20 in its 2020/21 accounts. Any reconciliations will be made through the 2022/23 Scottish Budget.

2018/19 final outturn

16. The C&AG concluded that 'based on our procedures Scottish income tax revenue outturn for 2018/19 is fairly stated'.

17. The 2018/19 outturn calculation of £11.556 billion is largely based on established tax liabilities, after the tax owed has been finalised and the taxpayer records have been reconciled. The remainder is based on estimated liabilities. Estimation is required in some areas of the calculation because the income tax liability data is not available to identify the Scottish share of individual income tax liabilities, reliefs or other adjustments at the point the outturn is calculated. The net effect of these adjustments is to reduce the Scottish income tax outturn arising by £42 million (0.4 per cent of the outturn).

2019/20 provisional estimate

18. From 2018/19, HMRC changed its provisional estimate methodology. The estimate is based on data from its Survey of Personal Incomes (SPI). This amount is then compared to the liabilities from the latest Scottish income tax outturns and adjusted accordingly. HMRC performs this calibration because, to date, actual tax outturns have been lower than what the SPI data alone estimates.

19. This calibration adjustment reduced the provisional estimate for 2019/20 by £0.3 billion (2.3 per cent) to £11.703 billion. The C&AG concludes that HMRC's approach is reasonable, but outlines the continuing limitations described in previous reports in relation to using SPI data rather than previous outturn data as the starting point for the estimate.

20. The calibration adjustment previously applied to the provisional estimate for 2018/19 reduced the difference between the estimated and actual 2018/19 outturn to £104 million, or 0.9 per cent. This compares to a difference of £980 million (8.2 per cent) between the 2017/18 provisional estimate and the 2017/18 outturn, when no adjustment was made. This suggests that the adjusted methodology has improved its accuracy.

21. HMRC's provisional estimates in future years are likely to include larger amendments to reflect the impact of Covid-19 and other external factors. The C&AG recommends that 'HMRC should consider how it reflects the impact of Covid-19 in its calculation of the revenue outturn and estimate for future years, including consideration of what additional data might be available to refine the calculation and better reflect the uncertainties caused by the pandemic.'

22. The risks to the budget caused by increasing uncertainty, complexity and volatility have never been higher, and it will be challenging to match spending to the available funding in the coming years. In my view, it is important that the Scottish Government and HMRC keep the estimation methodologies under review as more data becomes available to ensure they are as accurate as possible.

[4] Administration of Scottish income tax 2019-20, National Audit Office, January 2021.

Adequacy of HMRC's rules and procedures and compliance with these

23. The C&AG concluded that 'HMRC has adequate rules and procedures to ensure the proper assessment and collection of Scottish income tax and that those rules are being complied with'.

24. The administration of Scottish income tax is governed by a Service Level Agreement (SLA) between HMRC and the Scottish Government.[5] This is updated every year to reflect HMRC's planned work. The SLA sets out the requirements and performance measures for the operation of Scottish income tax. HMRC shares the results of assurance exercises and compliance activities with the Scottish Government throughout the year and publishes an annual summary of its performance against the requirements.[6]

25. The Scottish Income Tax Board meets quarterly as part of its annual cycle of governance and discusses the performance of HMRC procedures on Scottish taxpayer checks, PAYE reconciliations and compliance plans. The Scottish Government has told us this provides it with a high level of assurance over HMRC's administration of Scottish income tax.

26. Given the economic implications of Covid-19 and differences between Scottish and UK tax policies, it will be important to keep performance against the SLA and governance arrangements under continual review.

Scottish Tax Base

27. Accurate identification of Scottish taxpayers remains fundamental to the effective operation of the Fiscal Framework, to the size of the Scottish budget and in ensuring that the right amount of tax is collected from individuals.

28. The C&AG reports that HMRC has implemented processes to maintain the completeness and accuracy of the Scottish taxpayer population. This includes a series of checks on the overall taxpayer population.

29. HMRC conducted a third-party data check in November 2019, which was previously completed in November 2017. This involves comparing taxpayer address records held by HMRC with third-party data sources (including credit reference agencies and the electoral roll) to identify cases where HMRC records are inconsistent with third-party data. HMRC reported that its 2019 third-party data check suggested its record of Scottish taxpayers was 98-99 per cent accurate.[7]

30. Not all taxpayer records could be corroborated against third party information. Where this was the case, the addresses were instead checked against internal HMRC records. While there are 2.5 million NSND Scottish taxpayers, HMRC holds 5.2 million taxpayer records, including duplicates, temporary numbers, deceased taxpayers and inactive records.

31. From these taxpayer records, 78.7 per cent were able to be checked to third party data. Most of these records were matched, with only 8,587 mismatches. In the case of a mismatch, HMRC wrote to the address it held in its records, asking the taxpayer to confirm their address. The remaining 21.3 per cent of records were checked against internal data, such as information from Self Assessments and information from employers.

[5] HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 26 June 2019.
[6] Scottish Income Tax HMRC Annual Report 2020, HMRC, September 2020.
[7] Scottish Income Tax HMRC Annual Report 2020, HMRC, September 2020.

32. The process of matching against internal information where third party data is not available is in line with the SLA in place between HMRC and the Scottish Government, with third party checks being preferable. The C&AG has recommended that HMRC should 'review, by March 2022, how it can enhance the effectiveness of its third-party data comparison exercise in providing assurance over the accuracy of its address records.' The C&AG also recommended that HMRC consider whether there are any additional ways it can communicate with taxpayers to confirm addresses.

33. For the 2019/20 tax year, 45 MSPs had not initially been provided with a Scottish residency tax code. Following a period of weekly manual checks of MSPs tax codes (as NAO reported last year), in August 2020 HMRC introduced a system where MSP's are automatically assigned a Scottish residency code. This is fixed until the end of their parliamentary term. The NAO plan to audit this automated process as part of its 2020/21 audit.

Compliance risks

34. HMRC continues to assess compliance risk for Scottish taxpayers in the same manner as it does for the entire UK taxpayer population; through its Strategic Picture of Risk (SPR). The Scottish SPR identifies risks for Scottish income tax by taking the Scottish share of UK NSND income tax.

35. The C&AG reports HMRC estimated it generated an additional £210 million in Scottish income tax through its compliance activities in 2017/18; through generating additional revenues or preventing revenue losses. This is calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks.

36. The divergence of Scottish and UK tax policies presents the risk that taxpayers will manipulate their place of residence to reduce their tax liability. HMRC currently considers this risk to be very low compared to the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether. HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage.

37. The C&AG notes that HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Scotland compared with the rest of the UK. He also notes the UK Government's Committee of Public Accounts (PAC) recommends that HMRC should consider the benefits and challenges of estimating a Scotland-specific tax gap, which is the difference between the amount of tax that should be paid and what is actually paid.

38. In my view, further consideration of both the relative success of compliance activity in Scotland and the Scotland-specific tax gap would help assess whether any Scottish income tax compliance risks are emerging. This would help the Scottish Government to understand the compliance risks better, and any implications for its future tax policies.

The accuracy and fairness of the administrative expenses

39. The C&AG noted that 'based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2020 is accurate and fair in the context of the agreement between HMRC and the Scottish Government'.

40. HMRC initially estimated that total implementation costs associated with the introduction of SRIT would be up to £35 million. This was revised down to between £20 million and £25 million in April 2017, and to between £20 million and £23 million in April 2018.

41. HMRC has now completed its work to set up the systems needed to administer Scottish income tax. As noted in the C&AG's report, £24.3 million had been spent up until April 2020 on implementing the Scottish rate of income tax and the two associated HMRC projects: further Scottish income tax powers and relief at source.

Impact of tax outturns on the Scottish Budget

42. The block grant received from the UK Government remains the main source of funding for the Scottish budget. Since NSND income tax was devolved to Scotland in 2017/18, the block grant is now adjusted to take account of actual Scottish income tax revenues raised in Scotland. These are known as block grant adjustments (BGAs).

43. For Scottish income tax, the block grant is reduced by the amount of income tax foregone by HM Treasury by devolving it. Scottish income tax receipts are then added to the block grant in its place (Exhibit 1).

Exhibit 1
The block grant is adjusted for NSND Scottish income tax

Source: Audit Scotland

44. 2018/19 budget figures for Scottish income tax were based on independent forecasts prepared by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR). A budget adjustment (or 'reconciliation') is made in later years once outturn data is known.

45. The reconciliation resulting from 2018/19 outturn figures is a budget reduction of £309 million. This will be made through the upcoming 2021/22 Scottish budget. Forecasts originally increased the Scottish budget by £428 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish income tax receipts. Outturns show that the increase was £119 million, £309 million less than the forecasted difference (Exhibit 2, page 10).

Exhibit 2
How the Scottish Income Tax outturn relates to the 2021/22 budget reconciliation

£ million	BGA – reflecting income tax foregone by HM Treasury	Revenue from NSND Scottish income tax	Net effect on budget
Forecasts used for the 2018/19 budget	-11,749	12,177	428
Final outturn	-11,437	11,556	119
Reconciliation required through the 2021/22 budget (reduction)			**-309**

Source: Audit Scotland, based on Supplementary Forecast Evaluation Report: Income Tax, Scottish Fiscal Commission, October 2020

46. The Scottish Government has options on how to meet this reconciliation. It can do one or a combination of:

- borrow up to £300 million to cover most of the forecast error. This would protect the 2021/22 budget, but it would need to be repaid over three to five years, and would be on top of the £204 million it borrowed for the same purpose in the 2020/21 budget [8]
- use some or all of its Scotland Reserve balance
- reduce spending in other areas of the budget.

47. The budget challenges facing the Scottish Government are significant and are made more acute by the ongoing uncertainty and volatility caused by Covid-19. As the Scottish Government navigates these challenges, it will need to direct resources towards its priorities, maintain transparency to the public and continue its focus on long-term outcomes for people in Scotland.

[8] Scottish Budget 2020-2021, Scottish Government, February 2020.

Administration of Scottish income tax 2019/20

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