

ADMINISTRATION OF THE SCOTTISH RATE OF INCOME TAX 2015/16

REPORT TO THE SCOTTISH PARLIAMENT'S PUBLIC AUDIT AND POST-LEGISLATIVE SCRUTINY COMMITTEE BY THE AUDITOR GENERAL FOR SCOTLAND

Introduction

1. The Scotland Act 2012 introduced new powers for the Scottish Parliament to apply a Scottish Rate of Income Tax (SRIT) to the non-savings, non-dividend income of Scottish taxpayers from April 2016. The UK income tax rates are reduced by ten pence for each tax band for Scottish taxpayers and the Scottish Parliament uses its powers to apply a single additional rate across all bands.
2. Taxes raised by the SRIT are added to the Scottish Government's budget and a corresponding reduction is made to the funding that the Scottish Government receives from the UK Government. For 2016/17, the Scottish Parliament approved the Scottish rate at 10 per cent (ten pence), in effect matching the rates in the rest of the UK.
3. HM Revenue and Customs (HMRC) collects and administers the SRIT and is responsible for the project to implement it. The Scottish Government is responsible for funding the project, ensuring that the cost of the SRIT represents value for money, and for seeking assurances that the new system collects the correct amount of tax.
4. The Scottish Government reimburses HMRC for implementing the SRIT. Relevant costs are identified separately in HMRC's accounts and HMRC provides relevant extracts of its audited accounts to the Scottish Parliament for scrutiny each year.¹ For 2014/15 and 2015/16, costs relate only to the set-up of systems to calculate and collect the SRIT. From 2016/17, the first year of operation of the SRIT, HMRC's accounts will disclose the SRIT collected and the application of related rules and procedures.
5. The Scotland Act 2016 extends the Scottish Parliament's tax-raising powers further. From 2017/18, the Scottish Parliament has the power to set the income tax rates and band thresholds (excluding personal allowances) that apply to all non-savings and non-dividend income tax paid by Scottish taxpayers.
6. This report relates to 2015/16, in which preparations for the implementation of the SRIT continued prior to the introduction of the SRIT in April 2016.

Audit and assurance

7. HMRC's accounts are audited by the National Audit Office (NAO). The Comptroller and Auditor General is required to report to the Scottish Parliament on HMRC's

¹ Memorandum of understanding on the Scottish rate of income tax, Scottish Government and HM Revenue and Customs, February 2013 (updated December 2016).

administration of the SRIT by 31 January of the financial year after the one to which the report relates.² Specifically, the Comptroller and Auditor General is required to report on:

- the adequacy of any of HMRC's rules and procedures put in place, in consequence of the Scottish rate provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions
 - whether these rules and procedures are being complied with
 - the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Scottish rate resolution; and
 - the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses incurred as a result of the charging of income tax.
8. The then Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on the SRIT.³ I make this report to the Public Audit and Post-Legislative Scrutiny Committee in response to that recommendation.
 9. The Comptroller and Auditor General and I have confirmed to the Scottish Parliament that we will work together to ensure that it receives appropriate reports on the operation of the SRIT. We have agreed a Memorandum of Understanding that describes our respective powers and responsibilities and sets out a framework for collaborative working.
 10. I report separately on the preparations for the implementation of the 2012 and 2016 Scotland Acts.⁴ I will report again in Spring 2017 on the progress of the Scottish Government and others in implementing the new financial powers. This will include my assessment of how the Scottish Government is working with HMRC to introduce the new income tax powers.

Audit Scotland's review of the NAO's audit work on SRIT

11. The Comptroller and Auditor General made his second annual report to the Scottish Parliament on the SRIT on 19 December 2016. His report relates to 2015/16. It considers the accuracy and fairness of the amounts reimbursed to HMRC by the Scottish Government and the progress HMRC has made in implementing systems which will ensure the proper collection and assessment of income tax under the SRIT.
12. Audit Scotland considered the NAO's planning and approach to its audit work on the SRIT, discussing this with the NAO staff involved in the work. On completion of the NAO's audit work, Audit Scotland met with the NAO to review its documentation and the

² Section 80HA of the Scotland Act 1998, inserted by section 297 of the Finance Act 2014.

³ Public Audit Committee, 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax.

⁴ Preparations for the implementation of the Scotland Act 2012, Audit Scotland, December 2014; Implementing the Scotland Act 2012: an update, Audit Scotland, December 2015.

basis for the findings and conclusions included in the Comptroller and Auditor General's report.

13. In particular, Audit Scotland considered:

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

14. 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 the SRIT directly with HMRC. The judgements and conclusions set out in the report of the Comptroller and Auditor General are his alone, based on the audit work undertaken by the NAO on his behalf.

Conclusion

15. On the basis of Audit Scotland's review, I am satisfied that the NAO's approach was sufficient and robust 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.
16. In relation to the key findings in the Comptroller and Auditor General's report, I would in particular draw attention to the following matters.

Taxpayer identification

17. The Comptroller and Auditor General's key findings state that:

- *As a result of an error in the design of HMRC's taxpayer identification exercise in December 2015, 420,000 potential Scottish taxpayers did not receive a notification letter.*
 - *An interim solution was put in place by June 2016 to issue coding notices for the 2016/17 tax year to the 420,000 taxpayers omitted from the initial identification scan.*
18. Identification of Scottish taxpayers is fundamental to the effective operation of the SRIT and future devolved income tax. It is clear from the Comptroller and Auditor General's report that HMRC did not have effective controls in place to immediately recognise that the full intended population had not received a Scottish taxpayer notification letter. As a result of feedback from stakeholders (including the Scottish Government, employers and taxpayers) HMRC identified that the parameters it initially used to identify Scottish taxpayers had led to an incomplete population. HMRC implemented an interim solution in June 2016 and a permanent solution in October 2016. The NAO plans to assess the effectiveness of this in its report on 2016/17.

19. While there are no direct financial consequences for the Scottish Government or taxpayers as a result of this error in 2016/17, a robust taxpayer base is critical to the effective administration of Scottish income tax. The Comptroller and Auditor General notes that by not issuing the same level of information to people omitted from the initial identification exercise, HMRC may have created a less informed group of taxpayers.
20. The Scottish Government needs assurance that HMRC's taxpayer identification processes are now operating as intended, that the taxpayer base is robust and that work will continue to further refine the taxpayer population.

Communications strategy

21. The Comptroller and Auditor General's key findings state that:
 - *HMRC's ability to assure the amount of tax collected for the Scottish Government will be undermined where taxpayers fail to update their address details.*
22. Unless taxpayers keep their addresses up to date, they could pay the incorrect amount of tax. The Comptroller and Auditor General reports that HMRC spent £1.1 million in total on communications in 2015/16: £924,000 on taxpayer notification letters and £157,000 on other communications related expenditure. While further communication is expected, there is no specific communications expenditure on SRIT planned from 2016/17 onwards.
23. The Scottish Government needs assurance that HMRC's communications strategy is effective in promoting accurate taxpayer address information and that costs incurred provide value for money.

Other matters

24. The Comptroller and Auditor General's report also highlights that a future divergence of tax rates or thresholds between Scotland and the rest of the UK presents the possibility of tax avoidance and evasion. He also reports that the ability to provide an IT solution allowing personal pension providers to claim relief at source continues to be a significant risk.
25. This is the second year of audit reporting on the SRIT. I will continue to work with the Comptroller and Auditor General to develop our approach to the audit and assurance process relating to Scottish income tax powers, taking account of the views and comments of the Public Audit and Post-legislative Scrutiny Committee.