

# Administration of Scottish income tax 2017/18



AUDITOR GENERAL 

Prepared by Audit Scotland  
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## 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 (NSND) income of Scottish taxpayers from April 2016. This reduced the UK income tax rates by ten pence for each tax band for Scottish taxpayers, giving the Scottish Parliament power to apply a single additional rate across all bands. The Scotland Act 2016 extended the Scottish Parliament's power to vary all income tax rates and thresholds, but not the power to determine any 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 as part of the UK's overall income tax system. This includes separately identifying the amounts that relate to Scottish taxpayers. HMRC is responsible for the project to implement Scottish income tax. The Scottish Government is responsible for:
  - funding the project, by 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 new system collects the correct amount of tax.
3. The amount of Scottish income tax collected each year is identified separately in HMRC's annual accounts. The annual accounts for 2017/18 were published in July 2018.
4. This report relates to 2017/18, including the final outturn calculation of SRIT for the 2016/17 tax year and the first year's operation of the wider powers in the 2016 Act.

## Impact of tax decisions on the Scottish Budget

5. Scottish income tax revenues are added to the Scottish Government's budget. A corresponding block grant adjustment (BGA) deduction is made to the grant that the Scottish Government receives from the UK Government, based on relevant UK income tax policies. This represents the taxes the UK Government would have received in Scotland if Scottish income tax was not devolved. Broadly, the net effect on the Scottish budget depends on the extent to which the growth in Scottish income tax revenues per head is more or less than UK equivalents.
6. The final amount of Scottish income tax that will be collected and the associated BGA included in the Scottish Government's budget is unknown when the Scottish budget for any year is determined. Amounts included in the budget included are based on independent forecasts prepared by the Scottish Fiscal Commission (SFC) for Scottish NSND income tax receipts and the Office for Budget Responsibility (OBR) for the corresponding block grant adjustment. A budget adjustment (or 'reconciliation') is made in later years once outturn data is known.
7. The 2016/17 tax year was a standalone year as it was the first and final year in which the SRIT powers under the Scotland Act 2012 operated. The Scottish and UK Governments

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agreed that there would be no reconciliation between the forecast and outturn figures and forecasting errors would not have a direct impact on future budgets.

8. From the 2017/18 tax year reconciliations will have an impact on future budgets. HMRC will publish the final Scottish income tax outturn for 2017/18 in its 2018/19 accounts, which should be available in July 2019. The first reconciliations for Scottish income tax and the associated BGA are therefore expected to affect the 2020/21 Scottish Budget.
9. Audit Scotland's briefing paper [Scotland's new financial powers: Operation of the Fiscal Framework](#) provides more information on how the Fiscal Framework for the Scottish Government is operating in practice. It reflects on experience during 2017/18 and describes the range of risks that are now affecting the Scottish budget.

## HMRC's 2017/18 accounts

10. HMRC's Annual Report and Accounts for 2017/18 includes details of:
  - the final SRIT outturn for the 2016/17 tax year of £4.347 billion<sup>1</sup>
  - a provisional estimate of Scottish income tax revenue for the 2017/18 tax year of £11.896 billion.<sup>2</sup>
11. Alongside this HMRC published a more detailed explanation of how the final 2016/17 SRIT figure had been calculated in its Technical Note on 'Scottish income tax: figures in the 2017/18 HMRC Accounts'<sup>3</sup>. HMRC also calculated what the 2016/17 outturn figure would have been had the current (Scotland Act 2016) powers been in place.

## Audit and assurance

12. 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.<sup>4</sup> Specifically, the C&AG 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

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<sup>1</sup> This is rounded in the HMRC accounts but disclosed as £4.347 billion in the Comptroller and Auditor General's report – para 1.2.

<sup>2</sup> This is rounded in the HMRC accounts but disclosed as £11.896 billion in the Comptroller and Auditor General's report – para 1.3.

<sup>3</sup> Technical Note available from

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/724953/HMRC\\_ARA\\_2017-18\\_-\\_Scottish\\_income\\_tax.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/724953/HMRC_ARA_2017-18_-_Scottish_income_tax.pdf)

<sup>4</sup> Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.

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- 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.
13. The predecessor Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on the SRIT. I make this report to the Public Audit and Post-Legislative Scrutiny Committee in response to that recommendation.
14. The C&AG and I have confirmed to the Scottish Parliament that we will work together to ensure that it receives appropriate reports on the operation Scottish income tax. We have agreed a Memorandum of Understanding (MoU) that describes our respective powers and responsibilities and sets out a framework for collaborative working. It includes provision for review of the MoU to consider whether it needs to be revised due to changing circumstances. Such a review is will be due for the audit of 2018/19 arrangements and amounts.

## **Audit Scotland's review of the NAO's audit work on Scottish income tax**

15. The C&AG made his fourth annual report to the Scottish Parliament on 29 November 2018. His report relates to 2017/18 and considers:
- HMRC's calculation of the 2016/17 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
  - HMRC's estimation of the 2017/18 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 rate provisions
  - 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.
16. Audit Scotland's review focused on those areas outlined at paragraph 12. It considered the NAO's planning and approach to its audit work on Scottish income tax, 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 the basis for the findings and conclusions included in the C&AG's report.
17. In particular, 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 particular focus on the audit evidence underpinning the key findings and conclusions in its report; and

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- the NAO's arrangements for ensuring the quality of the audit work and reporting.
18. 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.
  19. The approach applied was in line with the provisions of the current MOU. The review of the MOU now due will allow the C&AG and me to consider whether the arrangements need to be revised to meet changing circumstances.
  20. The UK and Scottish Governments are developing an audit and accountability framework for devolved powers. This sets out how the Governments agree accountability and audit should operate in newly devolved areas, alongside existing arrangements and specific legal requirements. I have previously commented on a draft framework, including suggestions for strengthening it to better support the interests and responsibilities of the Scottish Parliament<sup>5</sup>. The Committee has also provided its views to both Governments. Decisions on the framework will ultimately be taken by the Ministers through the Joint Exchequer Committee. Audit Scotland and I will, of course, continue to work constructively with the Scottish Parliament, the Scottish Government and the NAO to deliver our responsibilities within the framework.

## Conclusion

21. 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 C&AG's report are reasonably based and I draw attention to the following matters.

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

22. The C&AG concluded 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'*.

### Scottish Tax Base

23. The C&AG notes that *'identifying the Scottish taxpayer population continues to be the main challenge to HMRC in administering Scottish income tax. HMRC undertakes a programme of annual checks on the overall taxpayer population.'*
24. Accurate identification of Scottish taxpayers is fundamental to the effective operation of the Fiscal Framework, and to ensure that the right amount of tax is collected from individuals. The C&AG reports that HMRC has implemented processes to maintain the completeness and accuracy of the Scottish taxpayer population. He concluded that HMRC's rules and

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<sup>5</sup> - Briefing paper available from [http://www.parliament.scot/S5\\_Public\\_Audit/General%20Documents/Briefing\\_paper\\_from\\_the\\_Auditor\\_General\\_5\\_February\\_2018.pdf](http://www.parliament.scot/S5_Public_Audit/General%20Documents/Briefing_paper_from_the_Auditor_General_5_February_2018.pdf)

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procedures for identifying Scottish taxpayers when address information is changed are now business as usual.

## Compliance Risks

25. The C&AG notes that HMRC continues to address compliance risk for Scottish taxpayers in the same manner as it does for the entire UK taxpayer population. HMRC undertakes an assessment of compliance risk specific to Scottish income tax based on its Strategic Picture of Risk (SPR).
26. The C&AG concluded that he was '*expecting the updated SPR, incorporating the latest income tax data and refreshed Scottish income tax risks, to be available for review to inform the findings of this report. Although we have been able to discuss its risk assessment work with HMRC, it is in the process of completing this work.*' As a result, he recommended that: '*HMRC updates the SPR as soon as possible, incorporating a detailed analysis of the available Scottish taxpayer data for 2016-17 to inform its ongoing compliance work.*'
27. The report highlights that HMRC considers that the compliance risk of incorrect residency was extremely low in 2017/18. In 2018/19 there were further divergences in the income tax rates and thresholds between Scotland and the rest of the UK. The report highlights that HMRC considers that the risk of non-compliance in 2018/19 will remain low due to the relatively small difference in tax liability. When the SPR is updated, the C&AG is '*interested in discussing HMRC's assessment of compliance risk for those taxpayers where the relative increase in tax is greatest.*'
28. HMRC considers that the main risk to income tax revenue in Scotland is from non-compliant behaviour from high earners with the aim of wholly avoiding or reducing income tax liabilities. HMRC considers that these risks apply to the whole of the UK and are not Scotland-specific. Whilst this is not a Scottish-specific risk, it may potentially affect the level of Scottish income tax collected and available as part of the Scottish budget.

## Tax relief on pension contributions

29. The C&AG outlines the work being done by HMRC to ensure Scottish taxpayers are identified within each pension scheme to ensure the correct tax relief is administered. HMRC expects that a new automated system will be place in April 2019. A temporary process was operated during 2017/18 to notify pension providers of their individual members' residency status.

## Correctness of the sums brought to account

### Final outturn

30. The C&AG concluded that '*The outturn of income tax revenue for the Scottish rate of income tax for 2016-17 is fairly stated.*'
31. The final outturn of £4.35 billion was £0.55 billion less than the forecast of £4.9 billion originally incorporated in the 2016/17 Scottish budget. This forecast was used for both tax revenues and the associated BGA. The Scottish and UK Governments agreed that there

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would be no reconciliation to outturn for the 2016/17 tax year. This means there is no direct impact on future budgets from this forecast error.

32. The Scottish and UK Governments also agreed that 2016/17 would be the baseline year for future BGAs. This means that the administrative data that sits behind the headline outturn figure, including the established taxable incomes of those identified as Scottish taxpayers in 2016/17, will be a key input for future budget calculations. This will:
  - inform the forecasts of future Scottish income tax revenues and the associated BGA incorporated into the Scottish budget from 2019/20
  - be an important component of the reconciliation adjustments made to the Scottish budget from 2020/21.
33. The C&AG notes that *'the calculation of the final outturn ... necessarily includes some remaining areas of estimation'* and that he has *'evaluated the basis of HMRC's estimate including the relevant assumptions and the available data'* in reaching his conclusion on the outturn figure. Estimation is required in some areas of the calculation because the income tax liability data is not available to specifically identify the Scottish share of individual income tax liabilities, reliefs or other adjustments.
34. The report outlines the components that make up the total 2016/17 SRIT outturn and provides a description of each. A summary of the elements based directly on Scottish taxpayer data and those that have been estimated is provided in exhibit 1. In total, £126.9 million of gross revenue and £156.22 million of deductions are based on estimates.

## Exhibit 1

### The data based and estimated components of the 2016/17 outturn figure

	Based on Scottish taxpayer data	Based on estimates for Scottish taxpayers	Total outturn
	£ million	£ million	£ million
PAYE established liability	2,927.90	10.50	2,938.40
Self assessment established liability	1,448.18	5.49	1,453.67
Further self assessment liabilities	-	83.23	83.23
Self assessment settlement agreements	-	27.68	27.68
Less: Relief at source	-	(72.99)	(72.99)
Less: Gift aid	-	(53.25)	(53.25)
Less: PAYE - uncollectable amounts	-	(18.97)	(18.97)
Less: Self assessment uncollectable amounts	-	(11.01)	(11.01)
Final outturn for 2016/17 tax year	<b>4,376.08</b>	<b>(29.32)</b>	<b>4,346.76</b>

Source: C&AG report

35. The C&AG has highlighted that estimation is a necessary part of the calculation of the final outturn for Scottish income tax, given the timescales for its calculation and the available sources of Scottish taxpayer specific data. Because of this, and how the agreed reconciliation process works, no subsequent correction of such estimates and their impact on Scottish budgets will be possible.
36. The C&AG has highlighted that the methodology for calculating the outturn has been agreed between the Scottish Government and HMRC. However, this has been across a variety of documents and discussions. He has therefore recommended that: *'the methodology is formalised by consolidating it into a single agreed document that forms a baseline position from which future refinements can be made'*.
37. 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.

### Final outturn on 2016 Act basis

38. While not shown in the HMRC 2017/18 Accounts, HMRC has also calculated what the 2016/17 outturn figure would have been had the current (Scotland Act 2016) powers been in

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place with all Scottish NSND income tax flowing to the Scottish Government. This information was included in HMRC's 2017/18 Technical Note and was not subject to audit by the NAO.

39. Using the available data HMRC has estimated that the final outturn for 2016/17 on this basis would have been £10.70 billion as outlined in its Technical Note. This was significantly less than previous forecasts, including the forecast of £11.27 billion prepared by the Scottish Fiscal Commission in May 2018. The SFC considered the reasons for this difference in its Forecast Evaluation Report in September 2018, noting that *'now that these data are available, they are the primary measure of total income tax liabilities in Scotland'*. It identified that:
- OBR, the Scottish Government and SFC have all published estimates of 2016/17 income tax liabilities that contained a similar and consistent overestimation of income tax liabilities
  - previous estimates were all based on the HMRC's Survey of Personal Incomes information for earlier years, which is based on its analysis of a one to two per cent sample of all income tax records
  - the previous overestimation is predominantly because of underlying differences between the survey methodology and outturn data. It has assessed that around £502 million of the £550 million forecast error in its May 2018 forecast was due to this
  - its previous modelling overestimated the number of taxpayers in 2016/17, with the scale of this error growing as the tax bands increase. It calculated that the existence of fewer higher and additional rate Scottish taxpayers than previously thought reduces the baseline for full Scottish income tax powers under the 2016 Act by £474 million. Fewer basic rate taxpayers than forecast reduces the baseline by £29 million.
40. While there will be no reconciliation adjustment made to the Scottish budget for the 2016/17 outturn, future budgets will be affected as a result of establishing the actual numbers of Scottish taxpayers for the first time. The budgetary impact will depend on the relative growth of income tax receipts in Scotland and the rest of the UK from this baseline figure. This will not be known until 2017/18 outturn data is published in July 2019 and will depend on the extent to which expected reductions in Scottish income tax revenues when compared to forecasts are offset by similar reductions in the BGA.

### **2017/18 Provisional estimate**

41. The provisional estimate of Scottish income tax revenue for 2017/18 of £11.896 billion is broadly in line with the £11.829 billion forecast incorporated into the 2017/18 Scottish budget. Both the estimate and the original forecast prepared by the Scottish Government are based on HMRC's Survey of Personal Incomes information, discussed above.
42. The C&AG notes that the methodology to estimate 2017/18 Scottish tax revenue was consistent with that applied in 2016/17. HMRC's initial estimate for 2016/17 using this methodology was £4.566 billion, which was 5% higher than the final outturn of £4.347 billion reported in this year's HMRC accounts. The estimate was calculated using a simulation model based on the HMRC Survey of Personal Incomes data from 2015/16 which does not draw on

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underlying Scottish taxpayer data. The C&AG notes *'the limitations that were outlined in our previous report are still applicable in 2017-18.'* These include:

- sample data introduces sampling uncertainty into the estimate of revenue from which the Scottish portion is calculated as a percentage
  - the method combines the calculation of PAYE and Self Assessment liabilities for the UK so the amount apportioned to Scotland does not reflect the differing proportions of each type of taxpayer between Scotland and the rest of the UK
  - the data used for PAYE includes all income types, it does not exclude NSND income
  - an assumption must be made around the volume and value of under and overpayments relating to PAYE liabilities.
43. The C&AG has noted that *'HMRC plans to refine its estimation methodology now it has a full year of Scottish income tax data for 2016-17'*. Using tax liability data in this way will improve future estimates, removing a number of the limitations inherent to use of the Survey of Personal Incomes.
44. The provisional estimate does not directly affect the Scottish budget. The Budget Process Review Group<sup>6</sup> proposed that the provisional estimate should be included in each year's Fiscal Framework Outturn Report (FFOR), in advance of final outturn information being available. The FFOR supports scrutiny of the operation of the Fiscal Framework and is important to full transparency and accessibility in the reporting of its operation.
45. The way the 2017/18 provisional estimate was constructed means it is of limited value in assessing the potential budget impact when reconciliation to the 2017/18 outturn takes place. The provisional estimate figure was not included in the 2017/18 FFOR. Planned improvements in methodology would improve the estimation and better inform Parliamentary scrutiny, the Scottish Government's ongoing financial management, and the forecasting and review processes that are now integral to the Scottish budget.

## The accuracy and fairness of the administrative expenses

46. 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 2018 is accurate and fair.'*
47. The Scottish Government reimburses HMRC for the net additional costs wholly and necessarily incurred as a result of the administration of the Scottish income tax powers. HMRC recharges costs that can be validated as specifically relating to the devolved Scottish income tax. In 2017/18, HMRC recharged £4.8 million of costs on the Scottish income tax projects, of which £0.3 million was annual running costs.
48. HMRC initially estimated that total implementation costs associated with the introduction on SRIT would be between £25 million and £30 million. This was revised down to £20 million to £25 million in April 2017, and to between £20 million and £23 million in April 2018.

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<sup>6</sup> Budget Process Review Group, Final Report, June 2017 at Paragraph 71  
[http://www.parliament.scot/S5\\_Finance/Reports/BPRG\\_-\\_Final\\_Report\\_30.06.17.pdf](http://www.parliament.scot/S5_Finance/Reports/BPRG_-_Final_Report_30.06.17.pdf)

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49. As noted in the C&AG's report, a £21.7 million had been spent up until April 2018 on implementing the SRIT and the two associated HMRC projects: further Scottish income tax powers and Relief at Source. HMRC estimates that a further £3.2 million will be spent on the remaining lifecycle of the project, largely to deliver the Relief at Source pensions system, meaning it anticipates a total cost of around £24.9 million.
  50. The C&AG notes that spending is now moving from implementation costs to business-as-usual costs.

# Administration of Scottish income tax 2017/18

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