

ADMINISTRATION OF THE SCOTTISH RATE OF INCOME TAX 2016/17

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. 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 this, 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. It reimburses HMRC for implementing and administering the SRIT.
3. The amount of SRIT collected each year and relevant costs reimbursed by the Scottish Government are identified separately in HMRC's annual accounts. HMRC's audited accounts for 2016/17 were published in July 2017.
4. The Scotland Act 2016 extends the Scottish Parliament's tax-raising powers. 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.
5. This report relates to 2016/17 following the introduction of the SRIT in April 2016.

Impact of tax decisions on the Scottish budget

6. Taxes raised by the SRIT are added to the Scottish Government's budget and a corresponding reduction is made to the block grant that the Scottish Government receives from the UK Government.
7. 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. The forecast revenue from the Scottish rate of income tax included in the Scottish budget for 2016/17 was £4.9 billion. A block grant adjustment to reduce funding by £4.9 billion was also made for 2016/17, based on the Office for Budget Responsibility's (OBR) forecast of income foregone for the UK government. Taken together these amounts were budget neutral.
8. As 2016/17 is a stand-alone year before the Scotland Act 2016 powers come into effect, there is no reconciliation required of tax revenue and block grant adjustments for this tax year to actual amounts. This means that the actual amount of income tax collected from Scottish taxpayers for 2016/17 does not affect the Scottish budget. From 2017/18

forecast amounts will be reconciled to actual figures once these are available, with corresponding adjustments made to subsequent budgets as set out in the fiscal framework.

HMRC's 2016/17 financial statements

9. HMRC administers SRIT as part of the UK's overall income tax system. It reported in its Annual Report and Accounts for 2016/17 that an estimated £4.6 billion of the total estimated tax revenues across the UK (£173.8 billion¹) relates to the SRIT.
10. This is an initial accounting estimate. As further information becomes available during 2017/18, including in relation to self assessment returns, HMRC will prepare a final figure for SRIT receipts in 2016/17. This will be done as part of its final reconciliation of UK income tax receipts for the year. The final amount will be reported in its Annual Report and Accounts for 2017/18. As noted above there will be no further adjustment to the Scottish block grant in respect of 2016/17.
11. HMRC's accounts also report that SRIT implementation and running costs for 2016/17 were £6.2 million.²

Audit and assurance

12. 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 administration of the SRIT by 31 January of the financial year after the one to which the report relates.³ 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.
13. The Public Audit Committee of the Scottish Parliament recommended that I should provide additional assurance on the NAO's audit work on the SRIT.⁴ I make this report

¹ This estimate includes non-savings, non-dividend income liabilities together with other adjustments for estimated under/over payments.

² The Comptroller and Auditor General's report highlights that total SRIT costs in 2016/17 were £6.3 million. Due to rounding, this revised figure is higher than the £6.2 million published in HMRC's annual report and accounts 2016-17, due to late receipt of an invoice for £33,000.

³ Section 80HA of the Scotland Act 1998, inserted by section 297 of the Finance Act 2014.

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

to the Public Audit and Post-Legislative Scrutiny Committee in response to that recommendation.

14. 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.
15. I have also reported regularly on the implementation of the new financial powers set out in the 2012 and 2016 Scotland Acts.⁵ I will report again on the continuing progress of the Scottish Government and others in Spring 2018.

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

16. The Comptroller and Auditor General made his third annual report to the Scottish Parliament on the SRIT on 27 November 2017. His report relates to 2016/17 and considers:
 - the collection of income tax from Scottish taxpayers
 - HMRC's estimate of income tax attributable to the Scottish rate of income tax in 2016/17
 - challenges in collecting tax from Scottish taxpayers
 - the cost of administering Scottish income tax, including whether the amounts repaid to HMRC by the Scottish Government are accurate and fair.
17. Audit Scotland's review focussed on those areas outlined at paragraph 12. It considered the NAO's planning and approach to its audit work on the SRIT, and discussed 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 basis for the findings and conclusions included in the Comptroller and Auditor General's report.
18. In particular, Audit Scotland considered the reasonableness of:
 - 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.
19. 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

⁵ Preparations for the implementation of the Scotland Act 2012, Audit Scotland, December 2014; Implementing the Scotland Act 2012: an update, Audit Scotland, December 2015; Scotland's New Financial Powers, Audit Scotland, September 2016; Managing New Financial Powers: an update, Audit Scotland, March 2017.

Comptroller and Auditor General are his alone, based on the audit work undertaken by the NAO on his behalf.

Conclusion

20. On the basis of Audit Scotland's review as set out in paragraph 18, 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.

Key matters

21. In relation to the Comptroller and Auditor General's report, I would draw attention to the following matters.

Income tax collected from Scottish taxpayers

22. The Comptroller and Auditor General's report states that:

- *While there are aspects of the methodology that could be enhanced, we have concluded that the estimate of income tax attributable to the Scottish rate resolution for 2016-17 is fairly stated.*
- *With actual Scottish taxpayer data now becoming available, HMRC has the opportunity to set out how this can be used to enhance its estimates of how much tax is attributable to Scottish taxpayers each year.*

23. The Comptroller and Auditor General's report assessed the features and limitations within the HMRC model to derive the estimate of SRIT revenues. As 2016/17 was the first year of SRIT, there was no prior year data to help inform the estimate. With the availability of Scottish data, there is scope for refining the calculation and the resultant estimate in future years. There is scope to use the 'S' codes to obtain data from the tax systems for Scottish Taxpayers to inform future revenue estimates.

24. The actual tax collected from Scottish Taxpayers in 2017/18 will be known in June 2019. The Comptroller and Auditor General's report notes that full details of how the reconciliation and adjustment process will work, is still to be confirmed.

Administration costs

25. In relation to amounts reimbursed to HMRC, the Comptroller and Auditor General's report states that:

- *The amount repaid by the Scottish Government for the year ended 31 March 2017 is fairly stated.*

26. The report refers to the range of performance data to be provided by HMRC to the Scottish Government. The performance data allows the Scottish Government to hold HMRC to account for its performance in administering the Scottish rate of income tax.

27. The report also refers to the impact on the administration costs if the Scottish rate diverges from the rest of the UK. The report notes that HMRC estimated running costs of between £2 million and £2.5 million if Scottish rates matched the rest of the UK and between £5.5 million and £6 million if the rates differed. The report outlines factors that could increase running costs such as the extent of changes to the band structure and the number of Scottish taxpayers affected.

Scottish Tax base

28. The Comptroller and Auditor General's report states that:

- *HMRC has now rectified the error from December 2015 that led to 420,000 Scottish Taxpayers not being identified.*
- *The biggest challenge facing HMRC is maintaining accurate address records of Scottish taxpayers.*
- *HMRC encourages taxpayers to tell it about changes of address, but does not know how successful its communications are.*

29. Identification of Scottish taxpayers is fundamental to the effective operation of Scottish income tax. The Comptroller and Auditor General's report notes that the permanent solution implemented in October 2016 was effective in correcting the parameters to identify Scottish taxpayers. HMRC verification checks confirmed that HMRC systems are able to correctly flag Scottish taxpayers based on the address data it holds.

30. The NAO assessed HMRC's residency rules and procedures and found that the process was operating as designed. The Comptroller and Auditor General's report notes that HMRC does not routinely check whether the number of days reported by taxpayers is accurate. HMRC does not consider that the current difference between UK and Scottish Government tax policies provides sufficient incentive for taxpayers to manipulate their residency status.

31. There is no legal requirement to notify HMRC of changes of address. The Comptroller and Auditor General's report highlights that while HMRC does not carry out checks to ensure the accuracy of taxpayer contact details, it has many sources of information on changes to addresses. This includes direct contact from the taxpayer, changes in self assessment forms and information from third parties.

32. The Comptroller and Auditor General's report highlights that keeping address details up-to-date will only become established taxpayer behaviour with a sustained communication campaign. HMRC has undertaken a range of communication activities to raise awareness about the SRIT, but it does not know how successful these have been. HMRC has no further spending plans on Scottish income tax specific communications.

Other matters

33. The Comptroller and Auditor General's report highlights that there was no risk of avoidance or evasion as a result of the Scottish rate of income tax in 2016/17, and that HMRC does not expect compliance risks to materialise in 2017/18. There was no specific compliance work undertaken in 2016/17 for SRIT. As part of its ongoing compliance activity, HMRC targets those groups considered to be more at risk of non-compliance activity.
34. The Comptroller and Auditor General notes that HMRC still has work to do to ensure people paying into pension schemes receive the right amount of tax relief. HMRC intends to introduce a fully functioning online system by April 2019.

Looking forward

35. The Scottish Parliament now has the power to set the income tax rates and band thresholds for non-savings non-dividend income for Scottish taxpayers. In 2017/18 it decided to set a lower higher rate tax threshold (£43,000) than the equivalent threshold for taxpayers in the rest of the UK (£45,000). The Comptroller and Auditor General's report notes that the Scottish Government has forecast income tax receipts of £11.857 billion for the year. The block grant was reduced by £11.750 billion based on the OBR's forecast of UK tax receipts foregone. This meant net additional funding of £107 million was included in the 2017/18 Scottish budget as a result of the decision made on Scottish Income Tax.
36. The forecast of Scottish tax revenue and the related block grant adjustment will be reconciled to the final outturn data when available, and any differences will be built into the following year's funding calculations. Final figures for 2017/18 will be included in HMRC's accounts for 2018/19, which are expected to be available in June 2019. Any adjustments would then be built into the 2020/21 budget. An initial estimate of receipts for 2017/18 will be available in HMRC's 2017/18 accounts.
37. The Budget Process Review Group was established by the Scottish Parliament to review the Scottish budget process in response to the new financial powers in the 2012 and 2016 Scotland Acts. Its report published in June 2017 included a package of recommendations that have been welcomed by the Scottish Government and the Finance and Constitution Committee. These include the introduction of an annual Fiscal Framework Outturn Report, to support scrutiny of the operation of agreed arrangements for new tax and social security powers and how these affect the Scottish budget. Audited information about initial estimates and final outturns for Scottish Income Tax included in HMRC's accounts will be a key component of such reports, the first of which is anticipated in Summer 2018.
38. The Comptroller and Auditor General's report highlights that any future divergence of tax rates or thresholds between Scotland and the rest of the UK presents the possibility of tax avoidance and evasion. As a consequence the extent of changes to tax rates and thresholds would influence the amount of compliance activity undertaken by HMRC to manage the risks of the changes and taxpayer behaviour.

39. This is the third year of audit reporting on Scottish income tax. 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.