Administration of Scottish income tax 2020/21

AUDITOR GENERAL

Prepared by Audit Scotland
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Contents

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. HMRC's accounts are audited by the National Audit Office (NAO) and the Comptroller and Auditor General (C&AG) issued his opinion on the 2020/21 HMRC Accounts in November 2021. 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.[1]

3. 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.[2] I make this report to the Public Audit Committee in response to that recommendation.

Key messages

- The National Audit Office's approach to providing assurance over Scottish income tax is reasonable and covers the key audit risks.
- The Scottish income tax outturn for 2019/20 is £11.833 billion, with Covid-19 having no substantial effect on HMRC's estimate of uncollectable revenue. The impact of the required reconciliation to the 2022/23 Scottish budget arising from this outturn is a reduction to the budget of £34 million.
- HMRC's provisional estimate of Scottish income tax for 2020/21 is £12.035 billion, which is within one per cent of the Scottish Fiscal Commission's most recent forecast for the year. The Scottish Government and HMRC should keep the outturn estimation methodologies under review as more data becomes available to ensure they are as accurate as possible.
- Given the continuing economic implications of Covid-19 and differences between Scottish and UK tax policies, the Scottish Government and HMRC should keep governance and assurance arrangements under continual review. This includes ongoing consideration of the frequency of third-party

[1] Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.

[2] 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax, Public Audit Committee, 2014.

data checks and Service Level Agreement performance measures, such as setting compliance target levels for Scottish taxpayers without 'S' prefixes.

- HMRC and the Scottish Government have recently published analysis of taxpayer behaviour in response to tax policy divergence. Further analysis of taxpayer behaviour, along with the relative success of compliance activity in Scotland and the Scotland-specific tax gap would help the Scottish Government to assess whether any Scottish income tax compliance risks are emerging.

Background

4. 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.

5. The Scottish Government has not made any further changes to tax bands. In 2019/20, the higher rate threshold for the rest of the UK (rUK) rose from £46,350 to £50,000 but remained unchanged for Scotland at £43,430.
In 2019/20, the Scottish Government increased by the rate of inflation the income thresholds for the starter, basic and intermediate tax bands, while rUK income threshold for the basic rate tax band was also increased by inflation.
In 2020/21, the income thresholds for the basic and intermediate tax bands were increased by inflation, while there were no further changes for rUK.

6. Total Scottish income tax revenues rose by 2.4 per cent between 2018/19 and 2019/20 compared to an increase of 2.3 per cent in NSND income tax revenues across the rest of the UK.[3]

7. HMRC collects and administers Scottish income on behalf of the Scottish Government 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.

[3] Scottish Income Tax Outturn Statistics: 2019 to 2020, HM Revenue & Customs, July 2021.

8. The amount of Scottish income tax collected each year is identified separately in HMRC's annual accounts. HMRC's annual accounts for 2020/21 were published in November 2021. This report relates to 2020/21, including the final outturn calculation of Scottish income tax for the 2019/20 tax year.

9. The NAO's 2020/21 report gives assurance over 2019/20 outturns. Some adjustments for Covid-19 have been made to the outturn for the 2019/20 financial year to reflect the impact of Covid-19 on HMRC's compliance and collection activity in 2020/21. This is the first year that outturn adjustments to account for Covid-19 have been made.

10. The report also covers the estimated outturn for 2020/21. While Scottish income tax revenues for 2020/21 will be affected by the pandemic, these estimates do not affect the Scottish budget.

Audit and assurance

11. 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.

12. The C&AG made his seventh annual report to the Scottish Parliament on 14 January 2022. His report relates to 2020/21 and considers:

- HMRC's calculation of the 2019/20 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2020/21 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.

13. 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.

14. 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.

Correctness of the sums brought to account

15. HMRC's 2020/21 Annual Report and Accounts included Scottish income tax outturn figures relating to the 2019/20 year. Scottish income tax in 2019/20 was £11.833 billion.[4]

16. For the 2020/21 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £12.035 billion. HMRC will publish the final Scottish income tax outturn for 2020/21 in its 2021/22 accounts, and an adjustment will be made to the 2023/24 Scottish Budget. The impact of tax outturns on the Scottish budget is explained in further detail at the end of this report.

2019/20 final outturn

17. The C&AG has concluded that Scottish income tax revenue outturn for 2019/20 is fairly stated.

18. The 2019/20 outturn calculation of £11.833 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.

19. The net effect of these estimation adjustments is to reduce the Scottish income tax outturn arising by £150 million (1.3 per cent of the outturn). The methodology used to arrive at these adjustments was agreed between the Scottish Government and HMRC at the Scottish Income Tax Board in February 2021. The C&AG notes that this methodology has remained broadly the same since the prior year.

The impact of Covid-19 on 2019/20 outturns

20. Lockdown measures in Scotland began on 23 March, near the end of the 2019/20 year. The C&AG states that HMRC identified the collectability of income tax as the key risk to the 2019/20 tax outturn. I note that for Scottish income tax, most of the outturn is based on tax already collected by the end of March 2021.

21. Estimated liabilities (amounts still expected from 2019/20 taxes but not yet received) includes a deduction for taxes that may never be collected. HMRC's calculation of this deduction is not based on the latest 2020/21 collection data, because HMRC undertook less compliance activity in 2020/21 due to Covid-19. Instead, HMRC used 2019/20 collection data.

[4] Administration of Scottish income tax 2020–21, National Audit Office, January 2022.

22. The overall estimate of uncollectable revenue deducted by HMRC from the 2019/20 outturn was £89 million. This is similar to the figure deducted from the 2018/19 outturn for uncollectable amounts, meaning that Covid-19 has not resulted in any substantial change to the overall collectability deductions to the Scottish outturn in 2019/20.

2020/21 provisional estimate

23. Since 2018/19 HMRC's provisional estimate methodology is based on data from its Survey of Personal Incomes (SPI). HMRC compares this amount to the liabilities from the latest Scottish income tax outturns and adjusts its estimate accordingly. HMRC performs this calibration because, to date, actual tax outturns have been lower than what the SPI data alone estimates. The C&AG notes that the methodology is largely consistent with that used to calculate last year's 2019/20 estimate.

24. HMRC identified the collectability of tax revenues as the key source of uncertainty arising from the impact of Covid-19 in 2020/21 and took account of this as part of its normal calibration adjustment. The 2020/21 calibration adjustment incorporates the 2019/20 final outturn, which already accounts for the estimated impact of Covid-19. This means that there is no separately identifiable estimate for Covid-19 impairments in 2020/21.

25. 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. The C&AG also concludes that the impact of Covid-19 on both the economy and individual taxpayers increases the level of uncertainty in HMRC's estimate of Scottish income tax revenue.

26. The 2020/21 calibration adjustment reduced the provisional estimate by £0.6 billion (4.5 per cent) to £12.035 billion. This compares to a reduction of £0.3 billion (2.3 per cent) applied to the 2019/20 provisional estimate last year. 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. However, I note that the Scottish Fiscal Commission's most recent forecast for 2020/21 of £11.938 billion is within one per cent of HMRC's provisional estimate.

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

27. 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.'

28. 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]

29. 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 (Pay As You Earn) 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.

30. 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

31. 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.

32. The C&AG reports that HMRC carries out several assurance activities to maintain the completeness and accuracy of the Scottish taxpayer population. This includes a series of checks on HMRC's records of Scottish taxpayers.

33. The Scottish Government and HMRC agreed in October 2020 that third-party data checks (where taxpayer address records held by HMRC are compared with third-party data sources) should be run every two years. The C&AG states that the latest third-party data check was undertaken in June 2021, but the data has not yet been analysed and does not form part of assurance work for 2019/20. The C&AG will report on his findings in its 2021/22 report next year.

34. The latest analysed third-party data check took place in November 2019. The C&AG reported its findings in last year's report. I highlighted last year that the check suggested HMRC's record of Scottish taxpayers was 98-99 per cent accurate. In my view, given the continued volatility caused by Covid-19, the Scottish Government and HMRC should keep the frequency of these checks under review. If the June 2021 data check demonstrates changes in accuracy of records, parties should consider if more frequent checks or further actions are required.

35. Checks undertaken in year include a variety of postcode checks to confirm correct residency, comparing PAYE submissions with HMRC records to confirm

[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 2021, HMRC, December 2021.

the ‘S’ code is correctly applied, and checks and procedures for high-net-worth individuals.

36. I note that there has been an increase in the number of missing postcodes identified, from 13,708 in July 2019 to 23,351 in September 2020. 3,914 cases were subsequently updated because they had a record of current employment or pension, compared to 1,391 in the prior year. The C&AG notes that, while the number of missing postcodes, has increased, it is still a very small proportion (less than one per cent) of the 2.5 million Scottish income tax population.

37. HMRC’s comparison of PAYE submissions to HMRC records in May 2020 identified 31,478 Scottish taxpayer records (1.3 per cent of cases) where employers were not operating a tax code with an ‘S’ prefix. By March 2021, there were 39,364 cases (1.2 per cent of cases). The C&AG states that HMRC were unable to confirm how many employers are repeatedly using the incorrect tax code.

38. The C&AG highlights that in previous reports he has noted that HMRC does not set a target as to how low the number of missing ‘S’ prefixes would be before it considers its compliance activity has been successful. My view is that the Scottish Government should consider the scope to introduce such a target with HMRC. Scottish residents without ‘S’ codes should, but do not, pay Scottish rates of income tax. While the impact on the Scottish tax outturn may be limited, ensuring equity and fairness among taxpayers in Scotland is also clearly important.

39. In last year’s report, I highlighted that, for the 2019/20 tax year, 45 MSPs had not initially been provided with a Scottish residency tax code. HMRC previously used a manual process to identify these records and ensure they were recorded as Scottish taxpayers regardless of residency. This required communication of required information to HMRC by employers or parliamentarians themselves and was completed annually. The C&AG reports that system changes designed to remove the need to annually update parliamentarians’ records were introduced in August 2020, and that HMRC did not identify any issues in relation to Scottish Parliamentarians’ tax during 2020/21.

Compliance risks

40. 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.

41. The C&AG reports HMRC estimated it generated an additional £270 million in Scottish income tax through its compliance activities in 2019/20; through generating additional revenues or preventing revenue losses. The estimated revenue lost from risks identified in the SPR, such as tax evasion and not declaring income, is £800m.

42. Both figures are calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks. 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.

43. The C&AG has highlighted that HMRC has limited information on specific compliance activity undertaken in Scotland. Unlike the income tax system which can flag Scottish residents, HMRC's compliance system cannot readily identify people living in Scotland.

44. The C&AG has further highlighted that the impact of Covid-19, and HMRC's response to it, affected its core compliance activity in 2020/21 and will reduce the level of tax receipts that HMRC has collected through its compliance activities, as well as increasing the amount of debt that will become uncollectable. The debt balance for income tax was higher in 2020/21 than it was before the pandemic; almost £11 billion at the end of 2019/20 and more than £16 billion by the end of 2020/21. It was noted by C&AG that an analysis of income tax debt attributable to Scotland is not currently available.

45. The C&AG also reports on HMRC's response to a previous recommendation by the UK Government's Committee of Public Accounts (PAC) 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. The Scottish Parliament's Public Audit and Post-legislative Scrutiny Committee followed up this recommendation through correspondence in February and March 2021. HMRC responded that calculating a Scottish specific tax gap would be difficult due to methodological reasons, including the increased burden on taxpayers who would be selected for further enquiry, the additional HMRC resource which would need to be deployed, and the loss of Exchequer revenue associated with redeployment of compliance staff away from yield-bearing work.

46. The increased divergence of Scottish and UK tax policies presents an additional risk that taxpayers will manipulate their place of residence to reduce their tax liability. HMRC currently considers this risk to be low compared to the overall risk of non-compliance affecting taxpayers across the UK, such as efforts to avoid or reduce liabilities altogether.

47. The C&AG also reports that HMRC began work in 2020 looking into Scottish taxpayer liabilities and behaviour over time. HMRC published its analysis from this work on 16 December 2021. The Scottish Government also published on the same day its policy evaluation of Scottish Income tax based on this analysis. The NAO will review the findings of HMRC's work in its 2021/22 report. I agree with the C&AG's view that this type of behavioural analysis is increasingly important to support HMRC's assessment of compliance risk if tax rates and bands continue to diverge.

48. In my view, further consideration of taxpayer behaviour in response to tax policy divergence, along with 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

49. 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 2021 is accurate and fair in the context of the agreement between HMRC and the Scottish Government'.

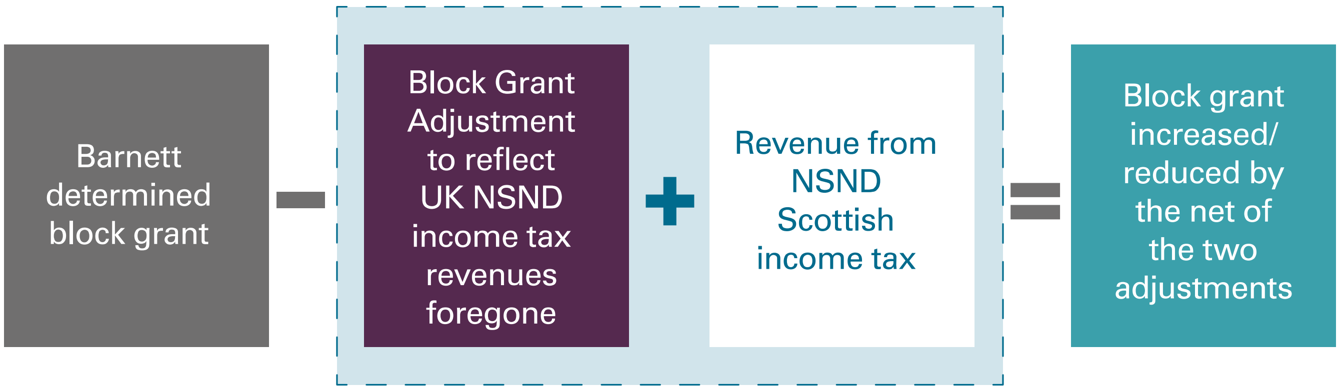
50. HMRC invoiced the Scottish Government for £0.7 million of costs relating to the administration of Scottish income tax in 2020/21 (£1.5 million in 2019/20). The reduction is due to 2020/21 being the first year since income tax powers were devolved to Scotland that costs relate exclusively to operating costs; 2019/20 was the last year that included implementation costs, which added £0.6 million to its operational costs of £0.9 million.

Impact of tax outturns on the Scottish budget

51. 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).

52. 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

53. 2019/20 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.

54. The reconciliation resulting from 2019/20 outturn figures is a budget reduction of £34 million. This will be made through the 2022/23 Scottish budget. Forecasts originally increased the Scottish budget by £182 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish income tax receipts. Outturns show that the increase was £148 million, £34 million less than the forecasted difference (Exhibit 2).

Exhibit 2
How the Scottish income tax outturn relates to the 2022/23 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 2019/20 budget	-11,501	11,684	182
Final outturn	-11,685	11,833	148
Reconciliation required through the 2022/23 budget (reduction)			-34

Source: Audit Scotland, based on Scotland's Economic and Fiscal Forecasts, Scottish Fiscal Commission, December 2021

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