Dear Mr Sarwar,

THE ADMINISTRATION OF SCOTTISH INCOME TAX 2018-19

Thank you for your letter of 7 May 2020, requesting further information about my report on the Administration of Scottish income tax 2018-19. My responses to the questions posed by your Committee are included alongside this letter.

I have sought to address the Committee’s questions as fully as possible in the context of my statutory reporting responsibilities under Section 80HA of the Scotland Act 1998, as amended by the Finance Act 2014. In doing so, I have made further inquiries of officials from HMRC and the Scottish Government since publishing my report on 8 January 2020 and referred to other published information relevant to the administration of Scottish income tax. Where I think there would be value in the Committee making further inquiries of HMRC directly, I have made recommendations to that effect in my response.

My team and I worked closely with the Auditor General for Scotland, and colleagues at Audit Scotland, throughout our audit and I am grateful for their co-operation and contribution.

I hope that you find my responses helpful in concluding your review for the 2018-19 reporting period. Work on my 2019-20 report has now commenced, which I look forward to engaging with you on in due course.

Yours sincerely

GARETH DAVIES
Annex - Administration of Scottish Income Tax 2018-19

Scottish Income Tax 2017-18 final outturn

Your report, Administration of Scottish Income Tax 2017-18, concludes that the Scottish income tax revenue outturn for 2017-18 is fairly stated, but states that:

“governance arrangements could be enhanced by formalising the full detail of the methodology in a single document that is ratified by all parties with any subsequent changes subject to approval by the Scottish Income Tax Board. This will support understanding of the process, strengthen the governance around changes to the methodology and form a baseline position from which future refinements can be made.”

Q1. Are you able to advise the Committee how this recommendation is likely to materialise and whether there are any barriers stopping it from happening?

Based on discussions between my team and HMRC officials, I understand that HMRC has contacted the Scottish Government regarding the formalisation of the methodology. I note that HMRC do not intend to make any significant changes to the methodology for the 2018-19 revenue outturn calculation.

The basis for my recommendation is in ensuring that there are appropriate governance and accountability processes in place to scrutinise and agree any changes to the methodology. I consider that having an agreed baseline and change control process for the methodology to be good governance practice in that respect. For example, in calculating the 2017-18 outturn there were more unreconciled taxpayer cases than in prior years. This resulted in a change to the methodology to include the unreconciled taxpayers in the outturn calculation, as opposed to just fully reconciled taxpayer records; this will now be permanently and prospectively adopted in the methodology.

I understand that HMRC have designed a process where the methodology used to calculate the revenue outturn will be subject to review and approval by the Scottish Income Tax Board annually ahead of the figure being calculated. My team has not yet audited this process for the most recent 2018-19 outturn; however, I consider the approval process proposed to be an improvement on the previous arrangements. I intend to follow up on the implementation of this recommendation as part of my 2019-20 report. In the meantime, HMRC officials will be best placed to provide an update on any barriers that may be preventing its timely implementation.

Scottish Income Tax 2018-19 estimate

The Committee notes that the 2018-19 estimates continue to be based on Survey of Personal Incomes (SPI) data, but that there is an “additional adjustment to calibrate the revenue estimate to the outturn”. Your report cites a number of the limitations with the SPI based methodology, including reliance on sample data; the amount apportioned to Scotland and assumptions made around the volume and value of under- and over-payments relating to PAYE liabilities.

Your report concludes that “HMRC should continue to improve the accuracy of the revenue estimate by incorporating more of the outturn data for Scottish income tax as it becomes available in future years.”
Q2. It seems clear to the Committee that actual 2017-18 outturn data would be a better source than SPI data (a point which was raised by Members last year). Are you able to advise the Committee of the following:

- why the 2017-18 outturn data was not used as the baseline for the 2018-19 estimate and what barriers prevented that from happening;

As you note, the current methodology for estimating the revenue is based on data from HMRC’s Survey of Personal Incomes, which uses a sample of taxpayer records. The limitations and inherent estimation uncertainty in the model are set out in my report.

The Scottish estimate is consistent with the methodology used by the Office for Budget Responsibility (OBR) to forecast income tax receipts at the whole-of-UK level. HMRC informed us that the main barrier is that use of outturn data would require an alternative methodology. This would require the development of specific economic assumptions for Scotland. HMRC’s tax forecasts are calculated based on UK-level economic determinants produced by the OBR. The OBR do not produce Scottish-specific economic determinants. These may mean HMRC is no longer consistent with other forecasts produced by the OBR and others.

The provisional estimate provides an indication of the revenue HMRC expects to collect for the current tax year for financial reporting purposes, but it does not impact upon the Scottish budget setting process. The provisional estimate is disclosed in HMRC’s Trust Statement accounts for the purposes of transparency in financial reporting. An estimate is produced by the Scottish Fiscal Commission (SFC), which is used in the Scottish budget setting process.

Having considered the relative significance of the provisional revenue estimate, HMRC’s approach to addressing the financial reporting limitations of the SPI-based methodology is to calculate a calibration adjustment based on analysis of the historical outturn data compared to previous estimates. As HMRC acquires more outturn data for Scottish income tax over time, there is further scope for it to use this information to refine its future estimates of Scottish income tax revenue disclosed in the Trust Statement accounts.

For more information on the approach being adopted to address the barriers to more accurate reporting of the provisional estimate, the Committee may wish to make further enquiries of HMRC.

- whether there is any estimate of the difference between using the two different sets of data (outturn compared with SPI);

- what the estimated margin of error is in HM Revenue and Custom’s (HMRC) calculation of the revenue estimate; and

The calibration adjustment applied by HMRC to the 2018-19 revenue estimate was calculated by comparing the 2017-18 outturn with a revised 2017-18 revenue estimate, using the same methodology, and with the most recent assumptions and data. The 2018-19 provisional estimate has been scaled down by the percentage difference observed. The difference between the 2017-18 estimate calculated previously and the 2017-18 outturn calculated in 2019 was 3.6%.

The calibration adjustment assumes the same level of overestimation would have been evident going forward and is designed to correct for this by applying up to date known information to the
SPI data used in the provisional 2017-18 estimate. This gives an indication of the inherent error present within the estimate methodology based on SPI data before correction. However, any differences between the current methodology and an alternative method utilising the outturn as a baseline for the estimate would depend on the specific methodology adopted. This calibration is only an indication as to how basing the estimate on outturn data could change.

HMRC’s latest Income Tax Liabilities Statistics publication\(^1\), based on the Survey of Personal Incomes data, includes an assessment of the precision of the estimates. HMRC assess that the plausible range for the true figure for Scottish income tax liabilities is 3.4% around the central estimate. The OBR has also provided some analysis of the causes of the over-estimation in the forecasting methodology, which it considers arise from\(^2\):

- The accuracy of key assumptions about differences in population growth, economic performance and income growth.
- Changes in the underlying tax base growth, which could be due to taxpayers moving their main place of residence from Scotland.
- Incorrect identification of Scottish taxpayers within the SPI data.
- Sampling error in the Survey of Personal Incomes data i.e. higher than average sampling error being concentrated among Scottish taxpayers (OBR has previously disclosed that the forecast model over-estimated the number of higher and additional rate taxpayers).
- Tax reliefs which are not included in the SPI data and income tax model.

Providing assurance in respect of HMRC’s Income Tax Liabilities Statistics publication and the OBR’s analysis is beyond the scope of my audit. The Committee may wish to make further enquiries of HMRC to understand how it has applied these insights in refining its estimated revenue calculation.

- **what estimates and projections HMRC uses when sample data is not available or unclear and how that impacts on the overall figure?**

2018-19 Revenue Estimate

HMRC’s methodology for estimating Scottish income tax revenue is based on taxpayer data extracted from its Survey of Personal Incomes (SPI). The SPI data is a sample of UK Taxpayers. The overall UK income tax liability is, therefore, a projection of this data through a model known as the Personal Tax Model. Scotland’s percentage share of this tax liability is determined through analysis of the data, the process for which is set out in Figure 4 of my report. The 2018-19 revenue estimate is based on 2016-17 SPI data, with adjustments applied to account for changes in conditions since the SPI data was gathered. These adjustments included:

- an estimate for changes in the Scottish share of tax, due to budget changes after the data was gathered, which resulted in a 2.7% increase in the revenue estimate;

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\(^1\) HM Revenue & Customs, Income Tax Liabilities Statistics 2017-18 Survey of Personal Incomes, with projections to 2020-21 Supporting Documentation, June 2020

\(^2\) Office for Budget Responsibility, Devolved tax and spending forecasts, March 2019.
• an adjustment in line with the historical trend for the Scottish share of PAYE income observed within HMRC’s Real Time Information system resulting in a 1.4% decrease in estimate;

• for the 2018-19 revenue estimate, a calibration adjustment was introduced to take account of historical overestimation arising from the estimate methodology resulting in a 3.6% decrease in the overall estimate; and

• other adjustments are applied to estimate Scottish share of Gift Aid (reducing the estimate by 0.9%) for population change (reducing the estimate by 0.1%) and for other smaller adjustments reducing the estimate by less than 0.4%.

Accuracy of the Scottish tax base

The Committee recognises that the accuracy of the Scottish tax base and Scottish taxpayer identification is crucial to the operation of the Fiscal Framework, the resultant size of the Scottish budget and in ensuring that Scottish taxpayers are paying the correct amount of tax.

As you may be aware, during the evidence session with your predecessor last year, the Committee explored two particular issues concerning the accuracy of the Scottish tax base. The first of these concerned the fact that, in 2017/18, 30,000 Scottish taxpayers were initially taxed using UK tax rates rather than Scottish tax rates because they had failed to tick the correct box on their self-assessment form.

The Committee notes that, as a result of this error in 2017-18, HMRC now uses the taxpayer address held on their records to calculate tax liability rather than the tick box on the self-assessment form.

Secondly, the Committee explored reports that 45 MSPs had not initially been provided with an ‘S’ tax code for 2019-20. As a result of this error, the Committee notes that HMRC now checks the residency status, tax codes issued, and tax codes being operated by employers of Scottish parliamentarians on a weekly basis.

Your report further indicates that HMRC will also conduct manual checks on all Scottish parliamentarians prior to the issuing of tax codes for 2020-21.

Q3. The Committee notes the action that has been taken by HMRC to address concerns about the accuracy of the Scottish tax base. Are you confident that there are now sufficiently robust systems in place for identifying Scottish taxpayers?

To ensure that the right amount of tax is collected from individuals and allocated to the appropriate government it is essential that taxpayers’ address information is correct. HMRC has implemented several assurance processes to maintain the completeness and accuracy of its address data used to identify Scottish taxpayers, details of which are set out in my report.

HMRC’s assessment of the Scottish taxpayer population is unlikely to ever be completely accurate due to the time lag between residency status changing, HMRC being informed, and the change being processed on its systems. The key risk to the accurate calculation of Scottish income tax due occurs where residency status has not been correctly established by the time that the data used in the revenue outturn calculation is drawn from HMRC’s systems. There will also always be some element of non-compliant taxpayers who are not identified at either a Scottish or whole of UK level and contribute to the overall income tax gap.
Under the terms of the Service Level Agreement with the Scottish Government, HMRC are required to “identify and maintain an accurate and robust record of the Scottish income taxpayer population”, and have agreed with the Scottish Government to implement the following measures:

- Third party data comparison.
- Production of the Strategic Picture of Risk.
- On-going address cleansing exercises (including cross-border, ‘S’ codes, in year changes etc).

Based on the audit work undertaken, I consider HMRC’s processes for identifying the Scottish taxpayer population to be reasonable and consistent with the Service Level Agreement at the time my audit work was performed. As Scottish and UK tax rates diverge, the Committee will be aware that the risks around the completeness and accuracy of the taxpayer base could change, particularly where there is a perceived financial incentive for taxpayers to manipulate their residency status.

Q4. In particular, are you confident that the numbers of Scottish higher rate taxpayers have been accurately identified and, if so, are you able to provide the Committee with those figures?

As described under Question 3 above, HMRC has implemented several assurance processes to maintain the completeness and accuracy of its address data used to identify Scottish taxpayers, details of which are set out in my report. Based on the audit work undertaken, I consider HMRC’s processes for identifying the Scottish taxpayer population to be reasonable and consistent with the Service Level Agreement with the Scottish Government at the time my audit work was performed.

Scottish taxpayer numbers, including higher rate taxpayers, are publicly available. HMRC published Scottish Income Tax: Experimental Statistics 2016-17 & 2017-18 in July 2019, which includes analysis of Scottish taxpayer numbers based on the outturn data; there were 308,000 higher rate taxpayers in 2017-18. HMRC will be best placed to provide further details on this publication if the Committee would find that helpful.

Compliance risks

The Committee notes that HMRC considers that the risk of Scottish taxpayers manipulating their place of residence to reduce their tax liability to be a very low risk compared to the overall risk of non-compliance affecting taxpayers across the UK and that HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage.

Your report indicates that HMRC was conducting a third-party data check in November 2019 against taxpayer addresses to identify cases for further investigation against this risk, but notes that this exercise had not been performed since November 2017. Your report recommends that HMRC should consider whether the third-party data check should be completed annually.

Q5. How confident are you that risks of Scottish address manipulation for tax avoidance are low?

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3 HM Revenue & Customs, Scottish Income Tax: Experimental Statistics 2016-17 & 2017-18, July 2019
As noted by the Committee, HMRC has assessed that the risk of non-compliance through manipulating residency status to be low in 2018-19, due to the relatively low incentive arising from the different tax rates and thresholds. As stated in my report, my audit is designed to give reasonable assurance over the procedures put in place by HMRC and the correctness of the amounts calculated as Scottish income tax.

The Scottish Strategic Picture of Risk sets out estimates of the Scottish proportion of tax at risk as a result of the compliance risks facing the UK as a whole. Risks are only included in the Strategic Picture of Risk where HMRC considers the potential risk of tax loss to be £250m or higher. HMRC consider the risk of people manipulating their address to be resident in England or Wales to obtain a tax advantage to be low compared to the risks facing the tax system as a whole. The Scottish Strategic Picture of Risk, therefore, does not include an assessment of this risk.

HMRC has set out its risk assessment in the 2019 Scottish income tax Annual report. The report stated that for 90% of taxpayers below the higher rate threshold, the difference in tax is less than £200 and that the largest impact is for high earners, such as those earning over £150,000, where the difference in tax is 1%. This is consistent with our analysis however, our report also shows (Figure 8) that, proportionately, there is a larger percentage impact on individuals with income of around £50,000, where the difference in tax paid is 1.6% of gross income. At certain levels of income there are, therefore, perceived incentives for address manipulation.

In November 2019, HMRC repeated its third-party data verification exercise to corroborate taxpayer address records with other sources. This has not yet been audited by my team and will be reviewed in preparing my 2019-20 report, however, it should provide some indication of whether the risk is increasing following the greater divergence in tax rates in 2018-19. Notwithstanding, it should be noted that this verification exercise does not provide absolute confirmation. HMRC checks its data for inconsistencies with other sources such as credit reference agencies and the electoral roll, however, both HMRC’s data and/or the third-party data could, in theory, be incorrect.

I consider that the information provided by HMRC as part of my 2018-19 audit provided a reasonable assessment of the risks in relation to address manipulation for avoidance purposes. Where Scottish income tax continues to diverge and the incentive arising from differential tax liabilities increases, HMRC will need to continually reassess the risk specifically arising from address manipulation to affect residency status. HMRC has told my team it would plan a proportionate increase in its compliance effort according to the size of future differences between Scottish tax rates and the rest of the UK.

Q6. In your view, is HMRC doing all it realistically can to encourage employers and taxpayers to declare address changes?

The current approach to communications with taxpayers has been agreed between HMRC and the Scottish Government. HMRC are administrators acting on behalf of the Scottish Government, while Scottish Government are also accountable for Scottish income tax policy and direction. HMRC relies on routine communication with taxpayers and employers to encourage the timely disclosure of address changes. I am not aware of any significant,

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additional communications campaigns that have been entered into in that respect since the initial implementation period.

In accordance with my statutory reporting responsibilities, my audit has considered the “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” and consider them to be reasonable.

The Committee may wish to make further inquiries of HMRC and the Scottish Government to establish whether more could be done to encourage taxpayers and employers to declare address changes on a timely basis.

**Q7. Could you expand on why you consider annual third-party data checks to be necessary?**

The third-party data check provides HMRC with an additional level of assurance over the completeness and accuracy of the address data held on its systems. This is the principal check of address data held by HMRC against external data sources such as credit reference agencies and other third parties.

The other checks performed by HMRC are designed to identify internal errors in addresses held such as missing postcodes or postcodes that have been incorrectly entered into HMRC systems.

At present, the bi-annual nature of the checks mean that information could be unverified on HMRC’s systems for up to two years. Any Scottish taxpayer whose residence is incorrectly flagged at the point the outturn figure is established will be incorrectly included or excluded in the calculation. More frequent third-party data checks could lead to earlier identification of any increase in the risks to address compliance and whether further activity was needed to enhance the accuracy of the data HMRC holds.

The frequency at which the third-party data check is carried out is for HMRC and the Scottish Government to determine and is regularly discussed by them. The substance of my recommendation is that HMRC should consider with the Scottish Government whether the benefits of performing the third-party checks more regularly outweigh the additional costs involved.

**Administrative costs**

In 2018-19 HMRC invoiced the Scottish Government for £2.8 million of costs, of which £0.8 million were running costs.

Your report notes that “based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2019 is accurate and fair.”

**Q8. It would be helpful if you could set out your procedures for concluding that the administrative costs repaid by the Scottish Government are accurate and fair?**

The recharging of costs by HMRC to the Scottish Government is governed by a Service Level Agreement between the two parties. The Service Level Agreement specifies the basis on which HMRC recharges the “net additional costs wholly and necessarily incurred as a result of administering the devolved income tax powers”. This is supported by an agreed framework for recharging costs to the Scottish Government. HMRC only recharge those costs which can be
wholly allocated to administration of Scottish income tax. Where information isn’t available HMRC absorbs the costs.

As part of my audit, I review the governance and control processes in place around the recharging of costs by HMRC. My team’s examination of the costs and recharging process includes review of the allocation of costs to ensure that these are fair and accurate in accordance with the agreed framework. The recharged costs disclosed by HMRC are agreed back to the underlying accounting records.

**Q9. Are you able to advise the Committee what the £2.8 million comprises and whether any part of it relates to the errors made in identifying Scottish taxpayers discussed above?**

Of the £2.8m charged £0.8m relates to business as usual running costs and the remainder are project implementation costs. These are set out in the finance managers’ reports reviewed by the Scottish Government as part of the governance processes around costs recharged by HMRC. The full details of the types of items agreed to be recharged are specified in the recharging framework agreed between HMRC and the Scottish Government.

The information collected by my team as part of my 2018-19 is not sufficiently granular to determine the extent to which the amounts re-charged by HMRC includes costs arising from errors made in identifying Scottish taxpayers. The Committee may wish to follow this inquiry up with HMRC directly.
Dear Mr Sarwar,

THE ADMINISTRATION OF SCOTTISH INCOME TAX 2018-19

I previously wrote to you on 14 July 2020 with responses to the questions your Committee posed to me in respect of my report on the Administration of Scottish Income Tax 2018-19.

Since that time, my team has had further engagement with HM Revenue & Customs, which I have reflected as minor amendments in my final response alongside this letter. I would, of course, be happy to discuss any of the matters raised with you should you find that helpful.

Yours sincerely

Yours sincerely

GARETH DAVIES
Annex - Administration of Scottish Income Tax 2018-19

Scottish Income Tax 2017-18 final outturn

Your report, Administration of Scottish Income Tax 2017-18, concludes that the Scottish income tax revenue outturn for 2017-18 is fairly stated, but states that:

“governance arrangements could be enhanced by formalising the full detail of the methodology in a single document that is ratified by all parties with any subsequent changes subject to approval by the Scottish Income Tax Board. This will support understanding of the process, strengthen the governance around changes to the methodology and form a baseline position from which future refinements can be made.”

Q1. Are you able to advise the Committee how this recommendation is likely to materialise and whether there are any barriers stopping it from happening?

Based on discussions between my team and HMRC officials, I understand that HMRC has contacted the Scottish Government regarding the formalisation of the methodology. I note that HMRC do not intend to make any significant changes to the methodology for the 2018-19 revenue outturn calculation.

The basis for my recommendation is in ensuring that there are appropriate governance and accountability processes in place to scrutinise and agree any changes to the methodology. I consider that having an agreed baseline and change control process for the methodology to be good governance practice in that respect. For example, in calculating the 2017-18 outturn there were more unreconciled taxpayer cases than in prior years. This resulted in a change to the methodology to include the unreconciled taxpayers in the outturn calculation, as opposed to just fully reconciled taxpayer records; this will now be permanently and prospectively adopted in the methodology.

I understand that HMRC have now designed a process where the methodology used to calculate the revenue outturn will be subject to review and approval by the Scottish Income Tax Board annually ahead of the figure being calculated. My team has not yet audited this process; however, I consider the approval process proposed to be an improvement on the previous arrangements. I intend to follow up on the implementation of this recommendation as part of my 2019-20 report. In the meantime, HMRC officials will be best placed to provide an update on any barriers that may be preventing its timely implementation.

Scottish Income Tax 2018-19 estimate

The Committee notes that the 2018-19 estimates continue to be based on Survey of Personal Incomes (SPI) data, but that there is an “additional adjustment to calibrate the revenue estimate to the outturn”. Your report cites a number of the limitations with the SPI based methodology, including reliance on sample data; the amount apportioned to Scotland and assumptions made around the volume and value of under- and over-payments relating to PAYE liabilities.

Your report concludes that “HMRC should continue to improve the accuracy of the revenue estimate by incorporating more of the outturn data for Scottish income tax as it becomes available in future years.”
Q2. It seems clear to the Committee that actual 2017-18 outturn data would be a better source than SPI data (a point which was raised by Members last year). Are you able to advise the Committee of the following:

- why the 2017-18 outturn data was not used as the baseline for the 2018-19 estimate and what barriers prevented that from happening;

As you note, the current methodology for estimating the revenue is based on data from HMRC’s Survey of Personal Incomes, which uses a sample of taxpayer records. The limitations and inherent estimation uncertainty in the model are set out in my report.

The Scottish estimate is consistent with the methodology used by the Office for Budget Responsibility (OBR) to forecast income tax receipts at the whole-of-UK level. HMRC officials have stated that the main barrier to the use of outturn data is that this would require the development of specific economic assumptions for Scotland. HMRC’s tax forecasts are calculated based on UK-level economic determinants produced by the OBR. The OBR do not produce Scottish-specific economic determinants. These may mean HMRC is no longer consistent with other forecasts produced by the OBR and others.

The provisional estimate provides an indication of the revenue HMRC expects to collect for the current tax year for financial reporting purposes, but it does not impact upon the Scottish budget setting process. The provisional estimate is disclosed in HMRC’s Trust Statement accounts for the purposes of transparency in financial reporting. An estimate is produced by the Scottish Fiscal Commission (SFC), which is used in the Scottish budget setting process.

Having considered the relative significance of the provisional revenue estimate, HMRC’s approach to addressing the financial reporting limitations of the SPI-based methodology is to calculate a calibration adjustment based on analysis of the historical outturn data compared to previous estimates. As HMRC acquires more outturn data for Scottish income tax over time, there is further scope for it to use this information to refine its future estimates of Scottish income tax revenue disclosed in the Trust Statement accounts.

The Committee may wish to make further enquiries of HMRC to establish the barriers to more accurate reporting of the provisional estimate and the approach being adopted to address these.

- whether there is any estimate of the difference between using the two different sets of data (outturn compared with SPI);
- what the estimated margin of error is in HM Revenue and Custom’s (HMRC) calculation of the revenue estimate; and

The calibration adjustment applied by HMRC to the 2018-19 revenue estimate was calculated by comparing the 2017-18 outturn with a revised 2017-18 revenue estimate, using the same methodology, and with the most recent assumptions and data. The 2018-19 provisional estimate has been scaled down by the percentage difference observed. The difference between the 2017-18 estimate calculated previously and the 2017-18 outturn calculated in 2019 was 3.6%.

The calibration adjustment assumes the same level of overestimation would have been evident going forward and is designed to correct for this by applying up to date known information to the
SPI data used in the provisional 2017-18 estimate. This gives an indication of the inherent error present within the estimate methodology based on SPI data before correction. However, any differences between the current methodology and an alternative method utilising the outturn as a baseline for the estimate would depend on the specific methodology adopted. This calibration is only an indication as to how basing the estimate on outturn data could change.

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- The accuracy of key assumptions about differences in population growth, economic performance and income growth.
- Changes in the underlying tax base growth, which could be due to taxpayers moving their main place of residence from Scotland.
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- Sampling error in the Survey of Personal incomes data i.e. higher than average sampling error being concentrated among Scottish taxpayers (HMRC has previously disclosed that the model over-estimated the number of higher and additional rate taxpayers).
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Providing assurance in respect of HMRC's Income Tax Liabilities Statistics publication and the OBR’s analysis is beyond the scope of my audit. The Committee may wish to make further enquiries of HMRC to understand how it has applied these insights in refining its estimated revenue calculation.

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- an estimate for changes in the Scottish share of tax, due to budget changes after the data was gathered, which resulted in a 2.7% increase in the revenue estimate;

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2 Office for Budget Responsibility, Devolved tax and spending forecasts, March 2019.
• an adjustment in line with the historical trend for the Scottish share of PAYE income observed within HMRC’s Real Time Information system resulting in a 1.4% decrease in estimate;

• for the 2018-19 revenue estimate, a calibration adjustment was introduced to take account of historical overestimation arising from the estimate methodology resulting in a 3.6% decrease in the overall estimate; and

• other adjustments are applied to estimate Scottish share of Gift Aid (reducing the estimate by 0.9%) for population change (reducing the estimate by 0.1%) and for other smaller adjustments reducing the estimate by less than 0.4%.

**Accuracy of the Scottish tax base**

The Committee recognises that the accuracy of the Scottish tax base and Scottish taxpayer identification is crucial to the operation of the Fiscal Framework, the resultant size of the Scottish budget and in ensuring that Scottish taxpayers are paying the correct amount of tax.

As you may be aware, during the evidence session with your predecessor last year, the Committee explored two particular issues concerning the accuracy of the Scottish tax base. The first of these concerned the fact that, in 2017/18, 30,000 Scottish taxpayers were initially taxed using UK tax rates rather than Scottish tax rates because they had failed to tick the correct box on their self-assessment form.

The Committee notes that, as a result of this error in 2017-18, HMRC now uses the taxpayer address held on their records to calculate tax liability rather than the tick box on the self-assessment form.

Secondly, the Committee explored reports that 45 MSPs had not initially been provided with an ‘S’ tax code for 2019-20. As a result of this error, the Committee notes that HMRC now checks the residency status, tax codes issued, and tax codes being operated by employers of Scottish parliamentarians on a weekly basis.

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**Q3. The Committee notes the action that has been taken by HMRC to address concerns about the accuracy of the Scottish tax base. Are you confident that there are now sufficiently robust systems in place for identifying Scottish taxpayers?**

To ensure that the right amount of tax is collected from individuals and allocated to the appropriate government it is essential that taxpayers’ address information is correct. HMRC has implemented several assurance processes to maintain the completeness and accuracy of its address data used to identify Scottish taxpayers, details of which are set out in my report.

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also always be some element of non-compliant taxpayers who are not identified at either a Scottish or whole of UK level and contribute to the overall income tax gap.

Under the terms of the Service Level Agreement with the Scottish Government, HMRC are required to “identify and maintain an accurate and robust record of the Scottish income taxpayer population”, and have agreed with the Scottish Government to implement the following measures:

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**Q4. In particular, are you confident that the numbers of Scottish higher rate taxpayers have been accurately identified and, if so, are you able to provide the Committee with those figures?**

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Scottish taxpayer numbers, including higher rate taxpayers, are publicly available. HMRC published *Scottish Income Tax: Experimental Statistics 2016-17 & 2017-18 in July 2019*, which includes analysis of Scottish taxpayer numbers based on the outturn data; there were 308,000 higher rate taxpayers in 2017-18. HMRC will be best placed to provide further details on this publication if the Committee would find that helpful.

**Compliance risks**

The Committee notes that HMRC considers that the risk of Scottish taxpayers manipulating their place of residence to reduce their tax liability to be a very low risk compared to the overall risk of non-compliance affecting taxpayers across the UK and that HMRC has not identified any significant or widespread instances of taxpayers changing their address to obtain a tax advantage.

Your report indicates that HMRC was conducting a third-party data check in November 2019 against taxpayer addresses to identify cases for further investigation against this risk, but notes that this exercise had not been performed since November 2017. Your report recommends that HMRC should consider whether the third-party data check should be completed annually.

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3 HM Revenue & Customs, Scottish Income Tax: Experimental Statistics 2016-17 & 2017-18, July 2019
Q5. How confident are you that risks of Scottish address manipulation for tax avoidance are low?

As noted by the Committee, HMRC has assessed that the risk of non-compliance through manipulating residency status to be low in 2018-19, due to the relatively low incentive arising from the different tax rates and thresholds. As stated in my report, my audit is designed to give reasonable assurance over the procedures put in place by HMRC and the correctness of the amounts calculated as Scottish income tax.

The Scottish Strategic Picture of Risk sets out estimates of the Scottish proportion of tax at risk as a result of the compliance risks facing the UK as a whole. Risks are only included in the Strategic Picture of Risk where HMRC considers the potential risk of tax loss to be £250m or higher. HMRC consider the risk of people manipulating their address to be resident in England or Wales to obtain a tax advantage to be low compared to the risks facing the tax system as a whole. The Scottish Strategic Picture of Risk, therefore, does not include an assessment of this risk.

HMRC has set out its risk assessment in the 2019 Scottish income tax Annual report. The report stated that for 90% of taxpayers below the higher rate threshold, the difference in tax is less than £200 and that the largest impact is for high earners, such as those earning over £150,000, where the difference in tax is 1%. This is consistent with our analysis however, our report also shows (Figure 8) that, proportionately, there is a larger percentage impact on individuals with income of around £50,000, where the difference in tax paid is 1.6% of gross income. At certain levels of income there are, therefore, perceived incentives for address manipulation.

In November 2019, HMRC repeated its third-party data verification exercise to corroborate taxpayer address records with other sources. This has not yet been audited by my team and will be reviewed in preparing my 2019-20 report, however, it should provide some indication of whether the risk is increasing following the greater divergence in tax rates in 2018-19. Notwithstanding, it should be noted that this verification exercise does not provide absolute confirmation. HMRC checks its data for inconsistencies with other sources such as credit reference agencies and the electoral roll, however, both HMRC’s data and/or the third-party data could, in theory, be incorrect.

I consider that the information provided by HMRC as part of my 2018-19 audit provided a reasonable assessment of the risks in relation to address manipulation for avoidance purposes. Where Scottish income tax continues to diverge and the incentive arising from differential tax liabilities increases, HMRC will need to continually reassess the risk specifically arising from address manipulation to affect residency status. HMRC has told my team it would plan a proportionate increase in its compliance effort according to the size of future differences between Scottish tax rates and the rest of the UK.

Q6. In your view, is HMRC doing all it realistically can to encourage employers and taxpayers to declare address changes?

The current approach to communications with taxpayers has been agreed between HMRC and the Scottish Government. HMRC are administrators acting on behalf of the Scottish Government, while Scottish Government are also accountable for Scottish income tax policy and direction. HMRC relies on routine communication with taxpayers and employers to

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encourage the timely disclosure of address changes. I am not aware of any significant, additional communications campaigns that have been entered into in that respect since the initial implementation period.

In accordance with my statutory reporting responsibilities, my audit has considered the “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” and consider them to be reasonable.

The Committee may wish to make further inquiries of HMRC and the Scottish Government to establish whether more could be done to encourage taxpayers and employers to declare address changes on a timely basis.

**Q7. Could you expand on why you consider annual third-party data checks to be necessary?**

The third-party data check provides HMRC with an additional level of assurance over the completeness and accuracy of the address data held on its systems. This is the principal check of address data held by HMRC against external data sources such as credit reference agencies and other third parties.

The other checks performed by HMRC are designed to identify internal errors in addresses held such as missing postcodes or postcodes that have been incorrectly entered into HMRC systems.

At present, the bi-annual nature of the checks mean that information could be inaccurate on HMRC’s systems for up to two years. Any Scottish taxpayer whose residence is incorrectly flagged at the point the outturn figure is established will be incorrectly included or excluded in the calculation. More frequent third-party data checks could lead to earlier identification of any increase in the risks to address compliance and whether further activity was needed to enhance the accuracy of the data HMRC holds.

The frequency at which the third-party data check is carried out is for HMRC and the Scottish Government to determine and is regularly discussed by them. The substance of my recommendation is that HMRC should consider with the Scottish Government whether the benefits of performing the third-party checks more regularly outweigh the additional costs involved.

**Administrative costs**

In 2018-19 HMRC invoiced the Scottish Government for £2.8 million of costs, of which £0.8 million were running costs.

Your report notes that “based on our procedures, we have concluded that the amount repaid by the Scottish Government for the year ended 31 March 2019 is accurate and fair.”

**Q8. It would be helpful if you could set out your procedures for concluding that the administrative costs repaid by the Scottish Government are accurate and fair?**

The recharging of costs by HMRC to the Scottish Government is governed by a Service Level Agreement between the two parties. The Service Level Agreement specifies the basis on which HMRC recharges the “net additional costs wholly and necessarily incurred as a result of administering the devolved income tax powers”. This is supported by an agreed framework for
recharging costs to the Scottish Government. HMRC only recharge those costs which can be wholly allocated to administration of Scottish income tax. Where information isn’t available HMRC absorbs the costs.

As part of my audit, I review the governance and control processes in place around the recharging of costs by HMRC. My team’s examination of the costs and recharging process includes review of the allocation of costs to ensure that these are fair and accurate in accordance with the agreed framework. The recharged costs disclosed by HMRC are agreed back to the underlying accounting records.

Q9. Are you able to advise the Committee what the £2.8 million comprises and whether any part of it relates to the errors made in identifying Scottish taxpayers discussed above?

Of the £2.8m charged £0.8m relates to business as usual running costs and the remainder are project implementation costs. These are set out in the finance managers’ reports reviewed by the Scottish Government as part of the governance processes around costs recharged by HMRC. The full details of the types of items agreed to be recharged are specified in the recharging framework agreed between HMRC and the Scottish Government.

The information collected by my team as part of my 2018-19 is not sufficiently granular to determine the extent to which the amounts re-charged by HMRC includes costs arising from errors made in identifying Scottish taxpayers. The Committee may wish to follow this inquiry up with HMRC directly.