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Administration of Welsh income tax 2019-20

HM Revenue & Customs

REPORT

by the Comptroller and Auditor General

SESSION 2019–2021
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Administration of Welsh income tax 2019-20

HM Revenue & Customs

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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The National Audit Office study team consisted of:

Bradley Easton, Ben Rodin and Ben Thompson, under the direction of Darren Stewart

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

020 7798 7400
www.nao.org.uk
@NAOorguk

Key facts

1.4m

Welsh taxpayers in 2019-20

£2,008m

HM Revenue & Customs' (HMRC's) estimate of Welsh income tax revenue in 2019-20.

£1.4 million project implementation costs in 2019-20

£0.6 million costs of administering the Welsh rates of income tax in 2019-20

Summary

Introduction

Welsh income tax

1 The Wales Act 2014 amended the Government of Wales Act 2006 to give the Welsh Parliament the power to set the Welsh rates of income tax that will apply to the non-savings, non-dividend income of Welsh taxpayers from the 2019-20 tax year onwards.

2 From April 2019, the United Kingdom (UK) basic, higher and additional income tax rates were reduced by 10 percentage points and the Welsh Parliament had the power to apply Welsh rates. The sum of the reduced UK rates and the new Welsh rates determines the overall rate of tax paid by Welsh taxpayers (**Figure 1** overleaf). The Welsh Parliament set the Welsh rates of income tax at 10% across all bands, effectively matching the UK rates at 20% (basic rate), 40% (higher rate) and 45% (additional rate).

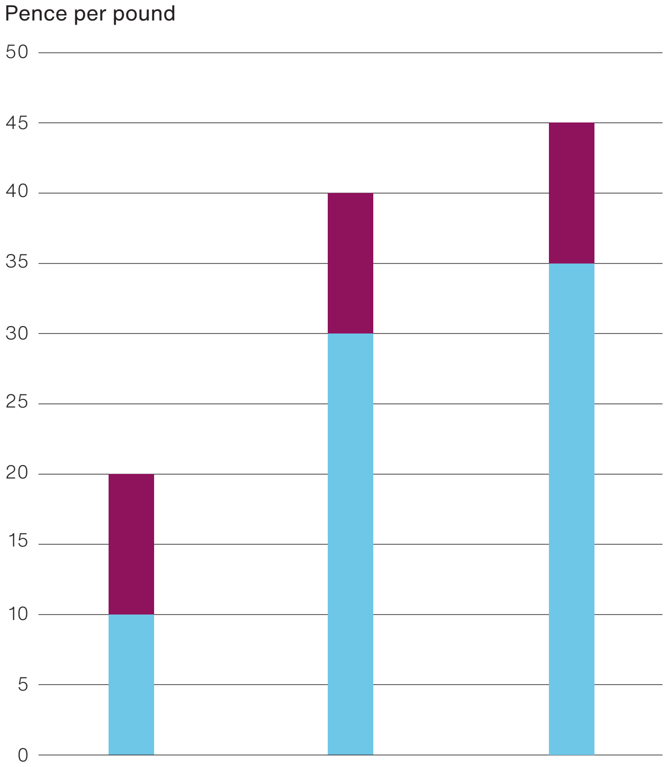
Roles and responsibilities

3 HM Revenue & Customs (HMRC) is responsible for the administration of the Welsh rates of income tax and continues to collect Welsh income tax as part of the UK tax system. HMRC will pay revenues collected in relation to the Welsh rates of income tax to HM Treasury in the same way as it does for all other tax receipts. HM Treasury is responsible for the payment of the Welsh income tax collected to the Welsh Government.

4 Following the end of each tax year, HMRC produces a provisional estimate of the Welsh income tax revenue for that year. The final outturn is calculated in the following year once HMRC has received further information from taxpayers and employers. This report covers the first estimate of Welsh income tax for 2019-20, following the implementation of the Welsh rates of income tax in April 2019. The outturn for 2019-20 is due to be published by HMRC in its 2020-21 Annual Report and Accounts.

Figure 1
Welsh rates of income tax for 2019-20

The UK rates of income tax are effectively reduced by 10p per £1 and replaced with the Welsh rates of income tax



	Basic rate	Higher rate	Additional rate
Welsh rate of income tax (pence)	10	10	10
UK income tax (pence)	10	30	35
Total	**20**	**40**	**45**

Notes

1 For each tax band (basic, higher and additional), the UK government reduces the amount of tax it will collect by 10 pence per £1 and the Welsh Government sets the Welsh rate of income tax to be added to the UK rates of tax.

2 For 2019-20, the Welsh Government set each Welsh rate of income tax at 10 pence, meaning that Welsh taxpayers pay an amount of tax equivalent to the UK rate for each tax band.

Source: The Welsh Government

Remit of the Comptroller and Auditor General

5 The Government of Wales Act 2006, as amended by the Wales Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of any of HMRC's rules and procedures put in place, in consequence of the Welsh 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 that is attributable to a Welsh rate resolution; and
- the accuracy and fairness of the amounts that are reimbursed by the Welsh Government to HMRC as administrative expenses.

6 This is our third report prepared under these responsibilities. It considers:

- HMRC's estimate of the 2019-20 income tax revenue attributable to Wales and our view on the methodology used (Part One);
- key controls operated by HMRC in the assessment and collection of income tax (Part Two);
- HMRC's approach to assessing and mitigating the risk of non-compliance with Welsh tax requirements (Part Two); and
- the cost of administering Welsh income tax – we provide assurance on whether the amounts are accurate and fair in the context of the costs incurred by HMRC (Part Three).

7 Appendix One sets out our audit approach and methodology.

Key findings and recommendations

Welsh income tax estimate 2019-20

8 **HMRC has estimated Welsh income tax revenue for 2019-20 as £2,008 million.** The methodology used to calculate the estimate is consistent with the methodology used by HMRC in estimating Scottish income tax revenue. For 2019-20, the calculation includes a reduction of £4 million to reflect HMRC's estimate of the economic impact of COVID-19 on taxpayer finances, which could result in amounts due to HMRC not being recovered. HMRC expects to calculate the finalised 2019-20 income tax revenue attributable to Wales, the 'outturn', in 2021 (paragraphs 1.2 to 1.9).

9 **The impact of COVID-19 on future outturns for 2019-20 and 2020-21 is yet to be determined.** Tax receipts across the UK have fallen since the onset of the pandemic. HMRC's compliance and debt collection activities have also reduced as a result of the impact of COVID-19 on the Department's capacity, measures taken to allow taxpayers more flexibility in making payments and the ability to physically engage with businesses and individuals. HMRC will need to consider whether further refinements to the calculation of future outturns and estimates are necessary, as more data become available, to better reflect the uncertainties caused by COVID-19 (paragraphs 1.10 and 1.11).

Administering Welsh income tax

10 **HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Welsh income tax and that those rules are being complied with**. Our work on devolved tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. We concluded that HMRC framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out (paragraphs 2.1 to 2.11).

11 **HMRC has not undertaken a comparison between its record of Welsh taxpayer residency status and third-party data since November 2018.** Maintaining an accurate and complete record of the home addresses of Welsh taxpayers to correctly determine residency remains the key challenge in administering the system. HMRC relies on taxpayers notifying it of a change of address, although there is no legal requirement for them to do so. In November 2018, HMRC undertook a comparison between its record of addresses and third-party data. This is HMRC's main source of assurance that the information it holds is accurate and complete, although the exercise was not undertaken in 2019-20. HMRC is currently in discussions with the Welsh Government about how frequently this work should be carried out, with the next exercise expected in 2020-21 (paragraph 2.22).

12 **As at April 2020, there were 43,000 Welsh taxpayers who had an incorrect tax code applied by employers and pension providers.** In May 2019, HMRC identified 198,000 Welsh taxpayers where the incorrect tax code was applied by employers and pension providers. The number of cases in May 2019 was higher than April 2020 due to issues with the software some employers use to process their payroll, as well as employer error. HMRC has worked with employers to resolve these issues, although work is continuing to target those employers and pension providers who continue to apply the 'C' prefix incorrectly. At the end of the tax year HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid. HMRC uses this information to calculate the tax liability that each Welsh taxpayer should pay. The revenue outturn for Wales is, therefore, unaffected where the 'C' prefix in an individual's tax code is not correctly operated by an employer (paragraphs 2.23 to 2.28).

13 **HMRC continues to assess the risk of non-compliance in relation to the Welsh rates of income tax as very low.** In 2019-20, HMRC produced a Welsh Strategic Picture of Risk (SPR) for the first time. HMRC considers the main areas of risk to Welsh income tax to be the same as those compliance risks which are tackled at the whole-of-UK level. There are no risks identified in the Welsh SPR specific to Wales. HMRC continues to assess compliance risks arising from Wales-specific elements as very low because tax rates remain the same as the UK rate. If there is divergence in the future, then this approach may need to change (paragraphs 2.31 and 2.32).

14 **HMRC calculated a compliance yield of £90 million relating to Wales for 2017-18, the most recent data available.** HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues that HMRC considers it has generated, and the revenue losses it has prevented. These figures are calculated based on a proportion of the UK figure as a whole, rather than using Welsh-specific data to quantify the risks. HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Wales compared with the rest of the UK (paragraph 2.33).

15 **The Committee of Public Accounts (the Committee) recommended that HMRC should consider the benefits and challenges of estimating a Welsh-specific tax gap, the difference between the amount of tax that should be paid and what is actually paid.** This would be a useful measure to understand how successful HMRC is in administering Welsh income tax. HMRC is due to respond to the Committee's recommendation by January 2021 (paragraph 2.34).

16 **HMRC has put in place appropriate governance arrangements to oversee the implementation and administration of the Welsh rates of income tax.** To manage the implementation of the Welsh rates of income tax, HMRC established a project governance structure within its wider devolution and change programme. In February 2020, the governance structure was adapted to reflect the fact that the Welsh rates of income tax project had been implemented and that the administration of the system had become part of HMRC's business-as-usual activities. The project to implement the Welsh rates of income tax project is due to be formally closed in 2021 (paragraphs 2.37 to 2.40).

Costs

17 **In 2019-20 HMRC incurred and recharged £2 million to the Welsh Government for the cost of administering the Welsh rates of income tax.** We examined HMRC's method for estimating the costs of collecting and administering the Welsh rates of income tax for the year ended 31 March 2020. Based on our audit work, we have concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government (paragraphs 3.1 to 3.7).

Recommendation

18 HMRC should consider how it reflects the impact of COVID-19 in its calculation of the revenue outturn and estimate for future years, including consideration of what additional data might be available to refine the calculation and better reflect the uncertainties caused by the pandemic.

Part One

Income tax collected from Welsh taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) Welsh income tax revenue estimate for 2019-20. This includes:

- HMRC's estimate of Welsh income tax revenue for 2019-20 including the features and limitations of HMRC's methodology (paragraphs 1.2 to 1.11); and
- an overview of Welsh income tax in 2020-21 and future years (paragraph 1.12).

The Welsh income tax estimate for 2019-20

1.2 HMRC estimates that it will collect £2,008 million of income tax from Welsh taxpayers for 2019-20.[1] The final outturn for the 2019-20 year will be calculated in May 2021 and is expected to be published in HMRC's Annual Report and Accounts 2020-21.

HMRC's revenue estimate for 2019-20

1.3 HMRC's methodology for estimating Welsh income tax revenue for 2019-20 is based on its Survey of Personal Incomes, which covers the whole of the UK. Wales' percentage share of the overall UK income tax liability is determined through analysis of the data in a model replicating the UK income tax system known as the Personal Tax Model.[2] The Welsh share is then applied to the total UK tax liability, which is calculated by combining actual Pay As You Earn (PAYE) receipts from 2019-20 with an estimate of Self Assessment liabilities for 2019-20 (**Figure 2** overleaf).

1.4 The methodology used by HMRC to calculate the 2019-20 revenue estimate is consistent with the approach used to calculate the equivalent estimate for Scottish income tax, as well as the methodology used by the Office for Budget Responsibility (OBR) to forecast income tax receipts for both Wales and the whole-of-UK.

1 HM Revenue & Customs, *Annual Report and Accounts 2019-20*, HC 891, November 2020.
2 The Survey of Personal Incomes contains the amount of income assessable to income tax alongside other information relating to a taxpayer. The survey data contain approximately 733,000 UK taxpayers and are drawn from multiple HMRC systems and include taxpayers from both PAYE and Self Assessment.

Figure 2

Method for calculating the 2019-20 Welsh income tax revenue estimate

The revenue estimate relies upon sample data and an apportionment of UK-wide estimates to calculate a Welsh share of income tax revenue

Survey of Personal Incomes

HM Revenue & Customs (HMRC) collected data from a 1.5% sample of UK taxpayers in 2017-18.[1]

→

Personal Tax Model

HMRC calculated the percentage share of UK income tax that related to Welsh taxpayers to be 1.17%.

→

Adjusted Welsh share

HMRC adjusted the percentage share to reflect changes to population, earnings and tax legislation since the Survey of Personal Incomes.

This resulted in a revised Welsh share of 1.16%.

→

Total UK income tax liability 2019-20

HMRC combined Self Assessment liabilities[2] with PAYE receipts to calculate the total liability[3] for the UK of £175.3 billion.

→

UK income tax liability after COVID-19 adjustment

HMRC reduced the total UK income liability by £356 million to reflect its estimate of the amount of income tax due at 31 March 2020 which may become uncollectable due to COVID-19.[4]

→

Total Welsh income tax liability 2019-20

HMRC applied the previously calculated Welsh share to the total income tax liability after adjustment for COVID-19. The estimate of Welsh income tax calculated was £2,008 million.

Notes

1 HMRC's annual Survey of Personal Incomes is a sample of UK taxpayers' data from the Pay As You Earn (PAYE) and Self Assessment tax systems. The Personal Tax Model (PTM) projects the outcome for income tax liabilities in 2019-20, taking into account adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Welsh share.

2 Total UK income tax liability 2019-20 is non-savings, non-dividend income only.

3 PAYE data comes from HMRC's Real-Time Information system. Self-Assessment data comes from HMRC's Self-Assessment Model.

4 The impact of the COVID-19 adjustment is to reduce the Welsh share of income tax was £4 million.

Source: National Audit Office analysis of HM Revenue & Customs data and calculations

1.5 HMRC's annual Survey of Personal Incomes is a sample of around 1.5% of UK taxpayers' data from HMRC's PAYE and Self Assessment tax systems. This process cannot begin until Self Assessment submissions are received, which is 10 months after the end of the tax year. Due to this timeline, the data used in the most recent Survey of Personal Incomes comes from the 2017-18 tax year.

1.6 The Personal Tax Model uses data adjusted to reflect demographic and policy changes that are expected or known to have taken place between 2017-18 and 2019-20. It models the outcome for income tax liabilities in 2019-20, adjusting for differing rates of population growth and economic factors, such as wage increases, to calculate the Welsh share of UK income tax liabilities.

1.7 Our review concluded that HMRC's approach is reasonable, however, there is scope for improving the accuracy of the calculation and there are limitations relating to the model itself:

- the use of sample data introduces sampling uncertainty into the estimate of revenue from which the Welsh portion is calculated as a percentage;
- the methodology combines the calculation of PAYE and Self Assessment liabilities for the UK such that the amount apportioned to Wales does not reflect the differing proportions of each type of taxpayer between Wales and the rest of the UK;
- the data used for PAYE include all income types and do not exclude tax from savings and dividend income; and
- based on historical data, HMRC assumes that receipts collected during 2019-20 represent 99% of total PAYE liabilities for the year. This does not consider the changing volume and value of underpayments and overpayments, which will be calculated after the end of the tax year as part of HMRC's reconciliation processes.

1.8 The equivalent calculation for Scottish income tax includes an additional adjustment to the estimate based on comparison of past estimates with historical outturns. This is not possible for the Welsh estimate of revenue because 2019-20 is the first year the Welsh rates of income tax have operated and no outturn data are yet available. As HMRC determines the outturn for Welsh income tax over time, there is scope for it to use this information to refine its future estimates of Welsh income tax revenue.

1.9 HMRC made an additional adjustment to reduce the estimate by £4 million to reflect the potential impact of COVID-19 on the collectability of tax revenues outstanding at the end of 2019-20. HMRC's assessment used varying sources of projected economic data, for instance, the estimated number of insolvencies that may arise as a result of COVID-19. The Welsh share of the overall UK income tax liability figure was then applied to determine the amount relevant to Wales. The methodology for the adjustment is subject to the following limitations:

- it is based on an estimate of the overall impact on tax receipts, with a further estimate of the proportion relating to income tax;
- it assumes that the impact of COVID-19 on the collectability of income tax is the same across the whole of the UK and does not account for any potential geographical variations; and
- the assumptions used in the estimate rely on forecasts of future economic conditions, for instance in respect of insolvency rates, which are inherently uncertain.

The impact of COVID-19 on the revenue outturn and estimate

1.10 COVID-19 is having a significant impact on the economy and, therefore, on receipts from taxes, as well as the collection of those receipts. The scale of the impact of COVID-19 is yet to be determined, but the following factors are likely to affect future outturns and estimates of Welsh income tax:

- Across the UK, from April to June 2020, tax receipts from income tax and National Insurance Contributions were at a lower level compared with the same period in 2019, although receipts in July 2020 and August 2020 slightly exceeded those in July 2019 and August 2019. The OBR forecast in November 2020 that total receipts for all tax revenues across the UK will fall by £57 billion in 2020-21 compared with the previous year.[3]
- HMRC reduced the number of new compliance cases it started. Across the UK, in April and May 2020, HMRC opened around one-third of the number of compliance cases that it opened at the same time in 2019. With many of its staff working from home; restrictions on travel and social distancing have affected HMRC's ability to visit customers and other staff have been reallocated to support the COVID-19 measures.
- HMRC also reduced its debt collection activity and, following the onset of the pandemic, did not undertake proactive campaigns with businesses and taxpayers to collect their tax debts, although some debt collection activities have now restarted, focusing on those customers least affected by COVID-19.

3 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 318, November 2020.

1.11 HMRC will need to consider whether further refinements to the calculation of future outturns and estimates are necessary, as more data become available, to better reflect the uncertainties caused by COVID-19.

Welsh income tax in 2020-21 and future years

1.12 The revenue outturn for 2019-20 will be calculated in 2021 and a new outturn will be calculated for each of the following years. HMRC has worked with the Welsh Government to develop the methodology for the Welsh income tax revenue outturn, which was formally agreed at the Welsh Rates of Income Tax Governance Board in August 2020. We will consider the revenue outturn for 2019-20 as part of our next report.

Part Two

Administering the Welsh rates of income tax

2.1 Part Two of this report covers:

- HM Revenue & Customs' (HMRC's) key processes in administering the income tax system and our approach to obtaining assurance on them (paragraphs 2.2 to 2.16);
- procedures used to identify and maintain a complete and accurate record of the Welsh taxpayer population (paragraphs 2.17 to 2.30);
- activity undertaken by HMRC to identify and respond to compliance risks (paragraphs 2.31 to 2.36); and
- governance arrangements for the ongoing administration of Welsh income tax (paragraphs 2.37 to 2.40).

2.2 The administration of income tax by HMRC utilises the same systems whether tax is received from a Welsh taxpayer or a taxpayer resident in the rest of the UK. HMRC operates some additional rules and procedures that are Wales-specific and we assess these in more detail below. This reflects HMRC's responsibility to administer income tax for Welsh taxpayers in a manner equivalent to the service provided elsewhere in the UK.[4]

2.3 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General is already responsible for considering the adequacy of the systems HMRC has in place for the assessment and collection of tax in the UK, including income tax. Each year we publish a report (the Standard Report),[5] alongside HMRC's Annual Report and Accounts, which sets out our conclusions in this respect. Our 2019-20 Standard Report concluded that HMRC had framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.

4 HM Revenue & Customs, *Service level agreement for operation of Welsh Rates of Income Tax (WRIT) by HMRC,* 26 June 2019.
5 Report by the Comptroller and Auditor General on HM Revenue & Customs 2019-20 Accounts.

2.4 To support the conclusions of the report, our UK-wide testing is extended to address the specific divergences caused by devolution. We also undertake specific procedures looking at HMRC's address cleansing and wider tax compliance activities to inform our assessment of the completeness and accuracy of HMRC's Welsh income tax estimates.

2.5 Having completed this additional work on devolved tax matters, we are satisfied that HMRC has adequate rules and procedures to ensure the proper assessment and collection of Welsh income tax, and that they are being complied with. In reaching our conclusions on these rules and procedures, we have also examined several other elements of devolved tax administration, including the ongoing maintenance of Welsh taxpayer records, the identification and response to devolved tax compliance risks and the progress of the relief at source project.

The income tax system

2.6 HMRC's system for collecting income tax is consistent across the UK. Depending on the type of income that an individual receives, income tax will be assessed and collected by employer's deductions from earnings through Pay As You Earn (PAYE), the taxpayer submitting a Self Assessment return, or both.

2.7 The PAYE and Self Assessment processes have common principles, despite utilising different IT systems and data sources to assess and collect tax. **Figure 3** overleaf identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.8 Our annual programme of audit work on HMRC includes procedures that provide assurance over the key tax processing controls. These controls can be broadly divided into two categories:

- automated system controls around data-handling, storage and processing; and
- key business controls that have a high level of automation but are complex.

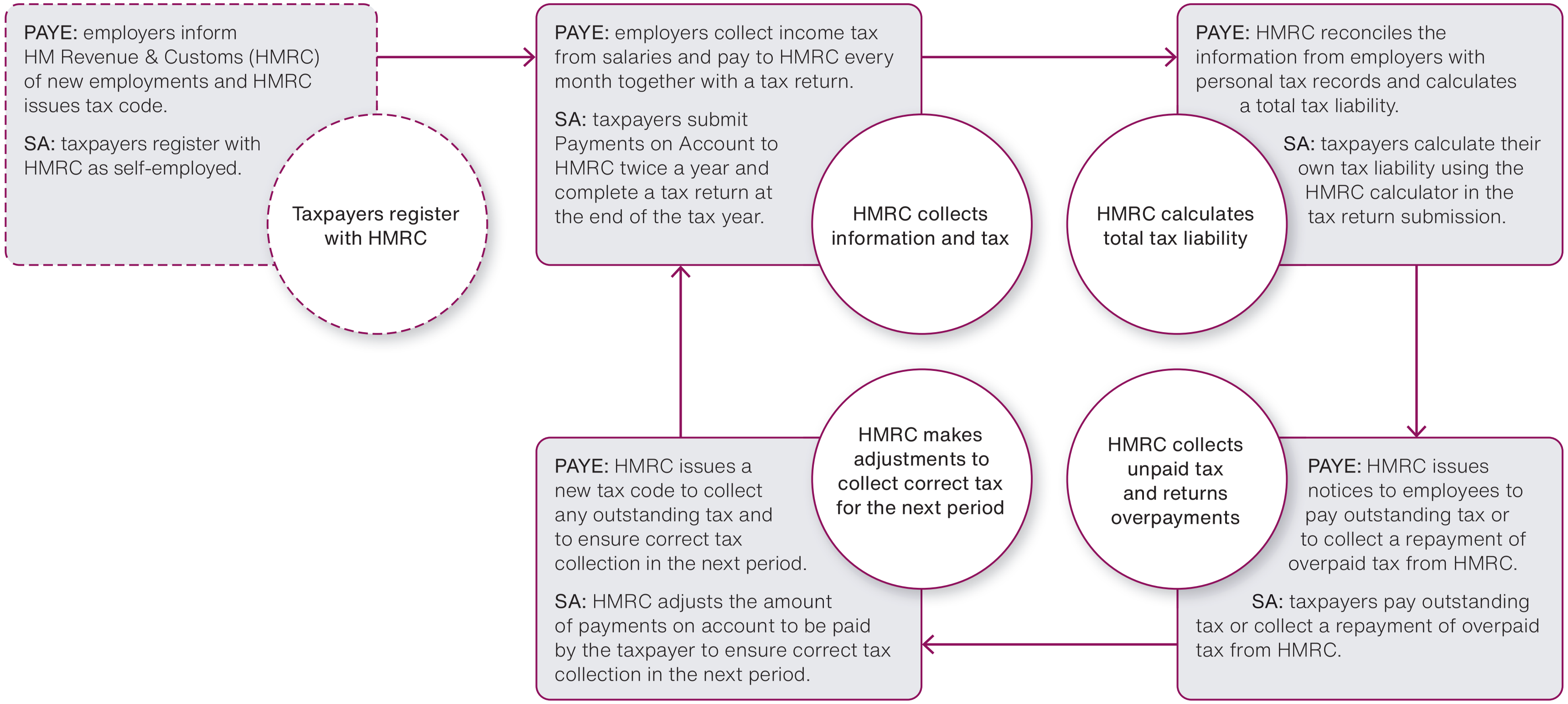
2.9 HMRC completes several phases of assurance testing on key business controls to confirm system functionality following the annual updates to business rules that reflect changing tax rates, thresholds and allowances for the UK and the devolved administrations. As part of our audit we evaluate the scope of this testing and reperform elements of the work to confirm HMRC's conclusions. The key processes in PAYE include annual:

- reconciliation of PAYE taxpayers to confirm the tax due on earnings and calculate any over- or under-payments of tax based on the country of residency; and
- issuing of tax codes to PAYE taxpayers which incorporate residency information to ensure that employers deduct tax under the tax rules of the correct country.

Figure 3

The current UK income tax system

The Pay As You Earn (PAYE) and Self Assessment (SA) processes share common principles in the assessment and collection of income tax



Notes

1 PAYE and Self Assessment processes do not occur simultaneously. PAYE is processed during the tax year and reconciled after the end of the tax year. Self Assessment returns are not submitted until the January following the end of the tax year.

2 After the tax year ends HMRC's PAYE reconciliation process calculates the income tax liability for each taxpayer using all available data. The calculated liability is compared with amounts deducted at source or collected from taxpayers directly to determine whether the correct amount of tax has been collected.

Source: National Audit Office analysis of HM Revenue & Customs processes

2.10 Similar processes are applied to each individual Self Assessment return once it is received by HMRC.

Devolved income tax

2.11 The only differences in the administration of devolved taxes, when compared with the UK processes, are the business rules that the system applies when completing the tax liability and tax code calculations. The rules for Welsh taxpayers are as follows:

- The system checks the residency status of the individual and where an individual has been identified as a Welsh resident applies the 'C' (for Cymru) tax code prefix. This instructs employers to collect tax under the Welsh tax rates. Where an individual is no longer resident in Wales the 'C' prefix is removed.
- Where an individual has been identified as a Welsh resident, the Welsh tax rates are applied to the reported income when calculating the liability for the current tax year.
- If an individual has been identified as a Welsh resident and they are enrolled on a PAYE scheme, the system uses the Welsh income tax rates to calculate a new tax code for the following year.

Figure 4 overleaf shows where these divergences occur within the income tax system.

Ongoing activity relating to the Welsh income tax project

2.12 HMRC implemented the Welsh rates of income tax on 6 April 2019 as planned. During 2019-20, HMRC implemented a change to how taxpayers submit online Self Assessment returns to enable them to identify as a Welsh resident. Further processes for administering tax relief on pension contributions in respect of Welsh taxpayers were also introduced.

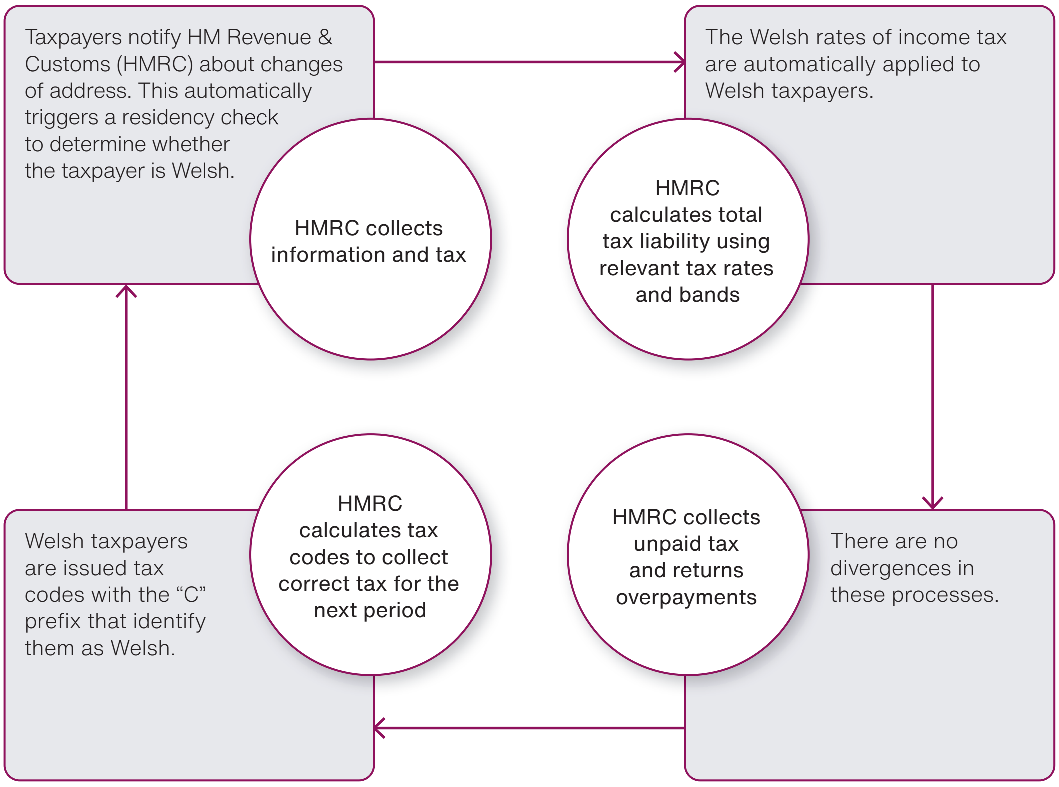
Online Tax Return for Self Assessment

2.13 The Online Tax Return for Self Assessment (OTRSA) project introduced a residency indicator to digital Self Assessment returns and this was successfully rolled out in April 2020. Online Self Assessment returns now include a check box for the taxpayer to state whether they were resident in Wales. Where a return is submitted by a Welsh taxpayer which has a different residency status to that held by HMRC, this is flagged by the HMRC systems as a discrepancy and a notification is issued to the taxpayer to confirm or update their address. If no action is taken, HMRC will calculate the income tax liability based on the residency status held on their systems.

Figure 4

Divergence in the current UK income tax system

The business rules are configured to process income tax using the rates and thresholds applicable to a taxpayers' residency status



Source: National Audit Office analysis of HM Revenue & Customs processes

Tax relief on pension contributions

2.14 It is important that Welsh taxpayers are identified within each pension scheme so that tax relief is allocated correctly. Pension administrators claim tax relief at source on behalf of their members and add this to the contributions made. The Relief at Source project (RAS) undertaken by HMRC introduces automatic confirmation of the residency status of pension scheme members to ensure the correct relief at source is applied by pension schemes. Under the RAS project, tax relief on pension contributions continues to be applied at the basic rate of 20% for all taxpayers. Welsh taxpayers who pay tax at a rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

2.15 To administer relief at source, HMRC requires that all providers submit an annual report, listing all member contributions in the previous tax year. HMRC's systems automatically trace scheme members and match them against the addresses held to identify Welsh taxpayers. An Annual Notification of Residency Report is then issued to pension providers.

2.16 HMRC had already developed the procedure for applying tax relief at source in relation to Scottish taxpayers. Wales was added to the existing framework in 2019-20, and final stages of implementation were conducted simultaneously with the costs apportioned between the respective governments.

Welsh taxpayer population

2.17 A Welsh taxpayer is someone with a tax liability whose main place of residence during the tax year is Wales. Welsh Parliamentarians are also deemed to be Welsh taxpayers. Maintaining accurate and complete records of the Welsh taxpayer population continues to be the main challenge to HMRC in administering Welsh income tax. HMRC has calculated the number of Welsh taxpayers to be 1.4 million.[6]

2.18 HMRC has many sources of information on changes of address. HMRC relies primarily on taxpayers informing it of any address changes on a timely basis, although taxpayers are not legally required to do so. HMRC also obtains some address information from other sources, such as employers. However, it is not a mandatory requirement for employers to provide updates when employee addresses change and, therefore, HMRC is unable to assess the accuracy and completeness of the information provided.

2.19 To ensure that the right amount of tax is collected from individuals and allocated to the Welsh Government it is essential that address information is correct. HMRC has implemented several assurance processes to maintain the completeness and accuracy of the address data used to identify Welsh taxpayers (**Figure 5** overleaf).

Postcode scans

2.20 HMRC receives a list of postcodes from the Office for National Statistics (ONS) on a quarterly basis. The list of postcodes received from the ONS is compared with those already held by HMRC. Where new postcodes are identified, HMRC adds these to the list of known Welsh postcodes. HMRC then carries out an internal verification process to confirm that the new postcodes have been correctly applied on the HMRC systems.

2.21 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. This was last performed in July 2019. The corresponding exercise was due to be undertaken in July 2020 but was delayed as a result of COVID-19 resourcing pressures on HMRC. HMRC is in the process of undertaking this work, with the intention that addresses will be corrected prior to the annual tax code exercise in early 2021. If the scans are not completed before tax codes are issued to employers, there is a risk that the tax codes will not correctly identify taxpayers as Welsh. We will evaluate and report on this process as part of our 2020-21 work.

6 HM Revenue & Customs, *Income tax liabilities statistics: tax year 2017 to 2018 to tax year 2020 to 2021*, HM Revenue & Customs, June 2020, Table 2.2, Number of income taxpayers by country.

Figure 5

Assurance activity over the Welsh taxpayer population

HM Revenue & Customs (HMRC) undertakes a number of assurance activities designed to maintain the completeness and accuracy of the Welsh tax base

Assurance activity	Purpose	Results
Controls ensuring Welsh residency is correctly determined using the address held by HMRC:		
New postcodes scan	A comparison of HMRC's list of Welsh postcodes with data from the Office for National Statistics (ONS) ensures HMRC's list is kept up-to-date.	Postcode data are received quarterly from the ONS. There were 575 new postcodes added in 2019-20.
Cross-border postcodes	HMRC's systems flag address changes where the new address lies in a postcode that crosses the England-Wales border. HMRC reviews these cases to ensure the correct residency status is determined.	This process has been in place since October 2019. In 2019-20, 79 cross border cases were manually reviewed under this process.
Address cleansing	Scans of taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied.	The scans undertaken in July 2019 of Welsh taxpayer records identified a total of 17,371 missing postcodes.[1] Of these, 2,047 cases were updated because they had a record of current employment. The remaining records were not updated because no employment was listed. HMRC also identified and reviewed 2,119 taxpayer records that had an invalid postcode.
Controls to identify incorrect addresses held by HMRC:		
Third-party data comparison	A comparison of taxpayer address records with third-party data sources to identify cases where HMRC records are inconsistent with third party data.	This assurance activity did not take place in 2019-20. HMRC plan to undertake the next data comparison in 2021.
Controls monitoring the operation of Pay As You Earn (PAYE) by employers:		
Tax code comparison scans	A comparison between tax codes in PAYE submissions with HMRC's taxpayer record, to identify cases where the employer is applying a different tax code to HMRC.[2]	The number of cases where 'C' prefixes were not applied to tax codes varied, although numbers have declined during the year. In May 2019 there were 198,344 cases identified and this fell to 42,623 in April 2020.

Notes

1 Invalid postcodes identified can be corrected or can be manually set as Welsh where the correct postcode cannot be determined from the address.

2 Amounts are from HM Revenue & Customs analysis of monthly tax code scans and show the number of tax codes where the Welsh 'C' prefix was not being correctly applied, and the tax code would have been otherwise correct.

Source: National Audit Office summary of HM Revenue & Customs activities

Third-party data comparison exercise

2.22 HMRC compares its records with third-party data to gain assurance over the accuracy of its address records and whether taxpayers are keeping their addresses up-to-date. The third-party data comparison exercise has not been carried out in 2019-20. HMRC is currently in discussions with the Welsh Government about how frequently this work should be carried out, although we understand that HMRC is proposing to run the third-party data comparison every two years from 2020-21, with agreement from the Welsh Rates of Income Tax Board expected in January 2021.

The administration of Welsh tax codes

2.23 Where an employer does not apply the 'C' prefix to an employee's tax code, they will deduct tax at the UK rate. At the end of the tax year HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid. HMRC uses this information to calculate the tax liability that each Welsh taxpayer should pay. The revenue outturn for Wales is, therefore, unaffected where the 'C' prefix in an individual's tax code is not correctly operated by an employer.

2.24 Each month HMRC compare tax codes in PAYE submissions with the taxpayer record to identify cases where the employer is operating a different tax code from that of HMRC. The number of cases where the 'C' prefix was not being operated varies across the year, although numbers have declined. In May 2019, HMRC identified 198,344 Welsh taxpayer records where employers were not operating a tax code with the 'C' prefix. In April 2020, this had fallen to 42,623 cases.

2.25 The number of cases in May 2019 was higher than April 2020 due to an issue with software some employers use to process their payroll, as well as employer error. HMRC undertakes routine compliance activity with employers to reduce the number of incorrect tax code prefixes in operation due to employer error. When HMRC identifies that an employer is not operating the correct tax code it issues a P6 notification asking the employer to update an employee's tax code.

2.26 HMRC's analysis identified that 50% of the cases identified in April 2020 related to taxpayers whose tax code had also been incorrectly applied in June 2019. HMRC is undertaking work to target those employers who make persistent errors and work with them to implement the correct tax code. HMRC has not set a target for how low the number of missing 'C' prefixes would have to be before it could say that it had been successful in its compliance activity.

2.27 It is possible that an employer could incorrectly apply the Scottish 'S' prefix rather than the Welsh 'C' one. In April 2019, there were 26,922 instances of the 'S' prefix being incorrectly applied to Welsh residents' tax codes. This arose because of the same software issue that resulted in the 'C' prefix not being applied correctly. In June 2019, there were 139 instances of employers operating a Scottish prefix instead of a Welsh 'C' one. By April 2020 this had fallen to 53.

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2.28 Where a Scottish prefix has been incorrectly applied to a Welsh taxpayer, there is a risk that the wrong amount of tax is deducted through PAYE due to the divergence of Scottish income tax rates. In this situation taxpayers may have to make additional payments in future years to offset an underpayment, or await a refund from HMRC for any amounts overpaid.

Welsh Parliamentarians

2.29 Welsh Parliamentarians are automatically deemed to be Welsh taxpayers in any tax year during which they are in office.[7] This applies to the 60 elected members of the Welsh Parliament along with 40 MPs in Westminster representing a constituency in Wales and four MEPs representing Welsh constituencies prior to the UK's exit from the EU.

2.30 Records relating to Welsh Parliamentarians are not processed using HMRC's normal business rules. HMRC has a manual process in place to identify the records of Welsh Parliamentarians and ensure that they are recorded as Welsh taxpayers regardless of their residency. This requires communication of required information to it by employers or from Parliamentarians themselves and must be completed annually. System changes designed to remove the need to annually update Parliamentarians' records were introduced in August 2020 and will be reviewed as part of our 2020-21 report.

Compliance risk assessment and planning

2.31 HMRC applies a risk-based compliance approach to the collection of Welsh income tax in the same way it is applied to the collection of income tax from taxpayers in the rest of the UK. HMRC's approach to tackling taxpayer non-compliance involves:

- promoting compliance with tax law by designing it into systems and processes, such as by making it easier for taxpayers to pay tax;
- preventing non-compliance before it occurs by using available data to spot mistakes, personalise services and support, block fraudulent claims and automate calculations; and
- responding by identifying and targeting the areas where there may be tax at risk.[8]

7 The Government of Wales Act 2006, as amended by the Wales Act 2014.
8 HM Revenue & Customs, *Tackling tax avoidance, evasion, and other forms of non-compliance*, March 2019.

2.32 The Service Level Agreement between HMRC and the Welsh Government states that a Welsh Strategic Picture of Risk (SPR) should be produced annually to consider compliance risk applicable to Wales. There are no risks identified in the Welsh SPR specific to Wales. HMRC considers the main areas of risk to Welsh income tax to be the same as those compliance risks which are tackled at the whole-of-UK level. Wales' exposure to these risks is assumed to be in line with Wales' share of UK income tax. The risks identified include:[9]

- registered individuals or businesses deliberately omitting, concealing or misrepresenting information in order to reduce their tax liabilities;
- the hidden economy, where an entire source of income is not declared or where a declared source of income is deliberately understated; and
- individuals undertaking tax avoidance, exploiting the tax rules to gain a tax advantage that Parliament never intended.

2.33 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield: its estimate of the additional revenues that HMRC considers it has generated, and the revenue losses it has prevented. In relation to the risks identified in the SPR, HMRC calculated a compliance yield of £90 million relating to Wales for 2017-18, the most recent data available. HMRC also calculated the Welsh share of net losses from the risks identified in the SPR to be £440 million. These figures are calculated based on a proportion of the UK figure, rather than using Welsh-specific data to quantify the risks. HMRC does not consider geographical variations in the level of compliance risk, or the relative success of compliance activity in Wales compared with the rest of the UK.

2.34 The tax gap is the difference between the amount of tax that should be paid and what is actually paid.[10] The Committee of Public Accounts (the Committee) recommended that HMRC should consider the benefits and challenges of estimating a Welsh-specific tax gap.[11] This would be a useful measure to understand how successful HMRC is in administering Welsh income tax. HMRC has not yet responded to the Committee's recommendation, but a response is expected in January 2021.

2.35 More broadly for 2019-20, HMRC has prepared a compliance strategy for the administration of the Welsh rates of income tax. HMRC continues to assess compliance risks arising from Wales-specific elements as very low because tax rates remain the same as the UK rate. If there is divergence in the future, then this approach may need to be revisited. HMRC told us that it has set up a project to look into both Scottish and Welsh taxpayer liabilities and behaviour over time and is in discussions with the Scottish and Welsh governments about what data might be useful to do this.

9 HM Revenue & Customs, *Measuring tax gaps 2019 edition*, June 2019.
10 HM Revenue & Customs, *Measuring tax gaps 2020 edition*, July 2020.
11 HC Committee of Public Accounts, *Tackling the tax gap*, Twentieth Report of Session 2019–2021, HC 650, October 2020.

2.36 Having completed our additional work on devolved tax issues, we are satisfied that HMRC has adequate rules and procedures to ensure the proper assessment and collection of Welsh income tax and that these are being complied with.

Governance

2.37 To manage the implementation of the Welsh rates of income tax, HMRC established a project governance structure within its wider devolution and change programme. A Wales Tax Devolution Project Board was set up to oversee the project and included representatives from both HMRC and the Welsh Government. There is evidence of constructive challenge by Welsh Government officials in these forums.

2.38 In February 2020, the governance structure was adapted to reflect the fact that the Welsh rates of income tax project had been implemented and that the administration of the system had become part of HMRC's business-as-usual activities. The Wales Tax Devolution Project Board ended and was replaced by a new Welsh Rates of Income Tax Board to oversee the ongoing administration of Welsh income tax. The Board comprises representatives from both HMRC and the Welsh Government and meets on a quarterly basis.

2.39 At the beginning of 2020, HMRC conducted a review of the project to assess project governance, delivery capability and planning, as well as readiness for full implementation into business as usual. The review concluded that the project was in a good position to successfully complete implementation of the Welsh rates of income tax. It also noted that the project team had taken steps to learn lessons from the implementation of the Scottish rates of income tax.

2.40 The project to implement the Welsh rates of income tax project is due to be formally closed in 2021 following the introduction of annual tax summaries for Welsh taxpayers. HMRC expects to undertake a Post-Implementation Review of the project, which we will consider as part of our 2020-21 report.

Part Three

Costs

3.1 This part considers the administrative costs of Welsh income tax, and whether these costs are reasonable.

3.2 Under the Memorandum of Understanding between HM Revenue & Customs (HMRC) and the Welsh Government, the Welsh Government is required to reimburse HMRC for "net additional costs wholly and necessarily incurred as a result of the administration of the Welsh income tax powers".

3.3 The supporting framework sets out the principles for identifying net additional costs. HMRC recharges costs that can be validated as specifically relating to the administration of devolved Welsh income tax powers and not the costs of administering the overall income tax system in Wales.

Costs incurred in 2019-20

3.4 HMRC invoiced the Welsh Government for £2 million of costs relating to the implementation and administration of Welsh income tax. Of this amount, £0.6 million related to running costs and £1.4 million related to implementation expenses, including the cost of systems required to administer the Relief at Source project.

3.5 We examined HMRC's method for estimating the costs of collecting and administering the Welsh rates of income tax for the year ended 31 March 2020. Based on our audit work, we have concluded that the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government.

Project costs to date

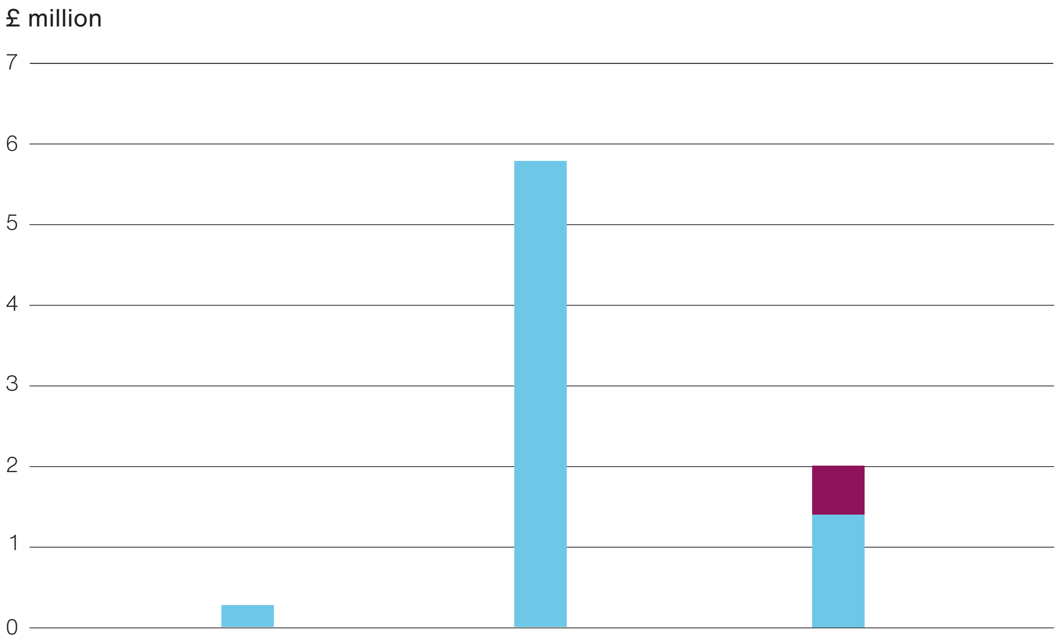
3.6 HMRC has estimated the overall cost of implementing Welsh income tax to be between £8 million and £9 million. Total expenditure so far in implementing the project is £7.5 million.

3.7 **Figure 6** provides a summary of the total cost of implementing and administering Welsh income tax.

Figure 6

Actual spending on Welsh income tax projects from 2017-18 to 2019-20

Spending incurred to date relates to implementation and operating costs



	2017-18	2018-19	2019-20
Operating costs	0	0	0.6
Implementation costs	0.3	5.8	1.4

Notes

1 Costs are for the Welsh rate of income tax project, annual tax summary project and the relief at source project.

2 Costs relating to the relief at source systems are apportioned between the Scottish Government and the Welsh Government.

3 Figures may not sum due to rounding.

Source: National Audit Office analysis of HM Revenue & Customs financial data

Appendix One

Our audit approach

1 Section 116k of the Government of Wales Act 2006, as amended by the Wales Act 2014, requires the Comptroller and Auditor General (C&AG) to prepare a report for each financial year on:

- the adequacy of any of HM Revenue & Customs' (HMRC's) rules and procedures put in place, in consequence of the Welsh rates 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 Welsh rates resolution; and
- the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses.

2 To reach the conclusions set out in this report in relation to the rules and procedures operated by HMRC we have drawn directly from our statutory audit work on HMRC's Annual Report and Accounts, including the C&AG's report on the controls operating within HMRC over the proper assessment, collection and allocation of tax under Section 2 of the Exchequer and Audit Departments Act 1921. We have also completed specific audit procedures over controls relevant to the administration of devolved taxes.

3 We have audited the data, methodologies, assumptions and mechanics of the calculation of the revenue estimate for 2019-20, which are described in this report. This work has been planned and completed by applying the principles set out in International Standards on Auditing (UK) 540 Auditing Accounting Estimates and Related Disclosures, to design audit procedures relevant to the nature of the estimates and to a sufficient level of precision.

4 In relation to administration costs our conclusion on the accuracy and fairness of the costs charged to the Welsh Government is based upon an evaluation of the costs against the details of the Service Level Agreement and the supporting framework for costs agreed between both parties. Some of the costs incurred are estimated by HMRC from available data on customer contacts and staff time. During the audit we also obtained evidence that both parties regularly discuss and review the cost budgets and forecasts as well as agreeing the amounts to be invoiced and paid.

5 All of these audit procedures have been planned, performed and reviewed in accordance with our internal quality control procedures for financial audit.

6 To present HMRC's approach to compliance risk we have reviewed published and unpublished HMRC documents about the Welsh rates of income tax, including project documentation, risk and compliance documentation and the details of key assurance work being performed by the HMRC.

7 This document review has been supplemented by semi-structured interviews with HMRC staff in a number of areas of the business. We also spoke to the Welsh Government and Audit Wales to inform our risk assessment and planning work for this report.

8 We reached our findings following our analysis of evidence collected between May and November 2020.

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