National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

Administration of Welsh income tax 2018-19

HC 25 SESSION 2019-20 8 JANUARY 2020

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HM Revenue & Customs

Administration of Welsh income tax 2018-19

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

18 December 2019

HC 25 | £10.00

The Wales Act 2014 amended the Government of Wales Act 2006 to give the National Assembly for Wales the power to set 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.

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Contents

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Key facts

2.0m

Welsh taxpayers[1] issued with notification letters

£2,101m

Welsh income tax forecast for 2019-20[2]

£5.8 million project implementation costs in 2018-19

£2.9 million HM Revenue & Customs' forecast of the remaining Welsh rates of income tax project implementation costs for 2019-20[3]

Notes

1 This includes those with income below the Personal Allowance, who would not be liable for income tax.

2 Office for Budget Responsibility (OBR), *Devolved Tax and Spending Forecasts*, March 2019, Table 1.4.

3 This includes £2.1 million relating to the implementation of the Welsh rates of income tax project and £0.8 million relating to relief at source. More information can be found in paragraphs 3.1 to 3.7.

Summary

Introduction

Welsh income tax

1 The Wales Act 2014 amended the Government of Wales Act 2006 to give the National Assembly for Wales (the Assembly) 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 are reduced by 10 percentage points and the Assembly has the power to apply Welsh rates. The sum of the reduced UK rates and the new Welsh rates will determine the overall rate of tax paid by Welsh taxpayers (**Figure 1** overleaf). The Assembly 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).

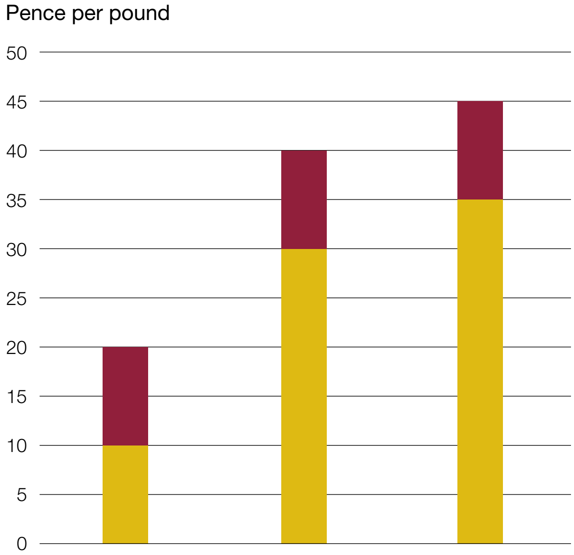
Roles and responsibilities

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 to the Welsh Government.

4 Each year, HMRC will report its estimate of revenue attributable to the Welsh rates provisions as part of its Annual Report and Accounts, published following the end of the financial year. The revenue must initially be estimated because the total income tax liabilities are not known until all Pay As You Earn (PAYE) taxpayer accounts are reconciled and income tax liability data are collected from Self Assessment taxpayers, which can take up to 10 months after the end of the tax year. The first estimate of Welsh income tax revenue for 2019-20 is, therefore, expected to be published in July 2020, with the outturn to be presented as part of the Annual Report and Accounts 2020-21, expected to be published in July 2021.

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**

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 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.

6 This is the second report prepared under these responsibilities and covers HMRC's preparations leading to the roll-out of the Welsh rates from April 2019. It provides:

- an overview of HMRC's approach to the administration of devolved income taxes and the Welsh rates in the context of the UK tax system (Part One);
- our findings from reviewing the implementation of the Welsh rates of income tax, including key events and timings (Part Two); and
- details of the cost of administering Welsh income tax, including whether the amounts are accurate and fair (Part Three).

7 This report does not consider the correctness of sums brought to account in relation to the Welsh rates of income tax, the adequacy of the rules and procedures put in place by HMRC or whether these rules and procedures have been complied with. These will be covered in our 2019-20 report on the Welsh rates of income tax. Appendix One sets out our audit approach and methodology.

Key findings

8 HMRC has established a project governance structure within its wider devolution and change programme and it is engaging with Welsh Government representatives across the full range of project activities. There is evidence of constructive challenge by Welsh Government officials in these forums, while HMRC has helped joint working by locating some of its project personnel in Cardiff. The Welsh Government is represented throughout the project structure, including the Welsh Income Tax Devolution Project Board and the supporting boards (paragraphs 2.5 and 2.6).

9 Maintaining a complete and accurate database of Welsh taxpayers is important to ensuring that HMRC can collect the correct amount of tax from Welsh taxpayers and allocate this to the Welsh Government. HMRC cleansed the data on its systems to recognise Welsh taxpayers and then corroborated its records to third-party data sources. In November 2018, HMRC issued 2.0 million bilingual taxpayer notification letters to Welsh taxpayers informing them of the Welsh rates of income tax (paragraphs 2.7 to 2.22).

10 HMRC regularly communicates with a diverse range of external audiences including employers, pension providers and other businesses that deliver payroll-related services to help ensure the Welsh rates of income tax project is implemented as intended. In May 2019, HMRC identified 174,000 Welsh taxpayers where the incorrect tax code was being applied by employers and pension providers. The application of incorrect tax codes was due to an issue within the payroll software being used by some employers. The application of incorrect tax codes was due to an issue within the payroll software being used by some employers, the timing of PAYE submissions by pension providers, and employer error or omission. HMRC found that its records were up to date. HMRC has been working with the affected employers to address and resolve these issues and ensure that the correct tax codes are being applied (paragraphs 2.29 to 2.35).

11 **In 2018-19, HMRC incurred and recharged £5.8 million of costs for implementing the Welsh rates of income tax.** We examined HMRC's method for estimating the costs of collecting and implementing the Welsh rates of income tax for the year to ensure this was reasonable in the context of the agreement with the Welsh Government. Based on our procedures, we have concluded that the amount repaid by the Welsh Government for the year ended 31 March 2019 is accurate and fair (paragraphs 3.1 to 3.7).

Part One

Administering the Welsh rates of income tax

1.1 Part One of this report includes an overview of the mechanics of the UK tax system, explaining where and how devolved taxpayers are identified and how HM Revenue & Customs (HMRC) administers and controls these processes.

1.2 This part of the report covers the:

- the key features of the income tax system in the UK (paragraphs 1.4 to 1.10);
- modifications that have been made to the income tax system to incorporate devolved taxes (paragraphs 1.11 and 1.12); and
- work conducted by the National Audit Office (NAO) in relation to the UK tax system (paragraphs 1.13 to 1.19).

1.3 Under Section 2 of the Exchequer and Audit Departments Act 1921 the Comptroller and Auditor General (C&AG) 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. In the 2018-19 Standard Report,[1] published alongside HMRC's Annual Report and Accounts, 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.

The income tax system

1.4 The income tax system 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 earning through Pay As You Earn (PAYE), the taxpayer submitting a Self Assessment return, or both.

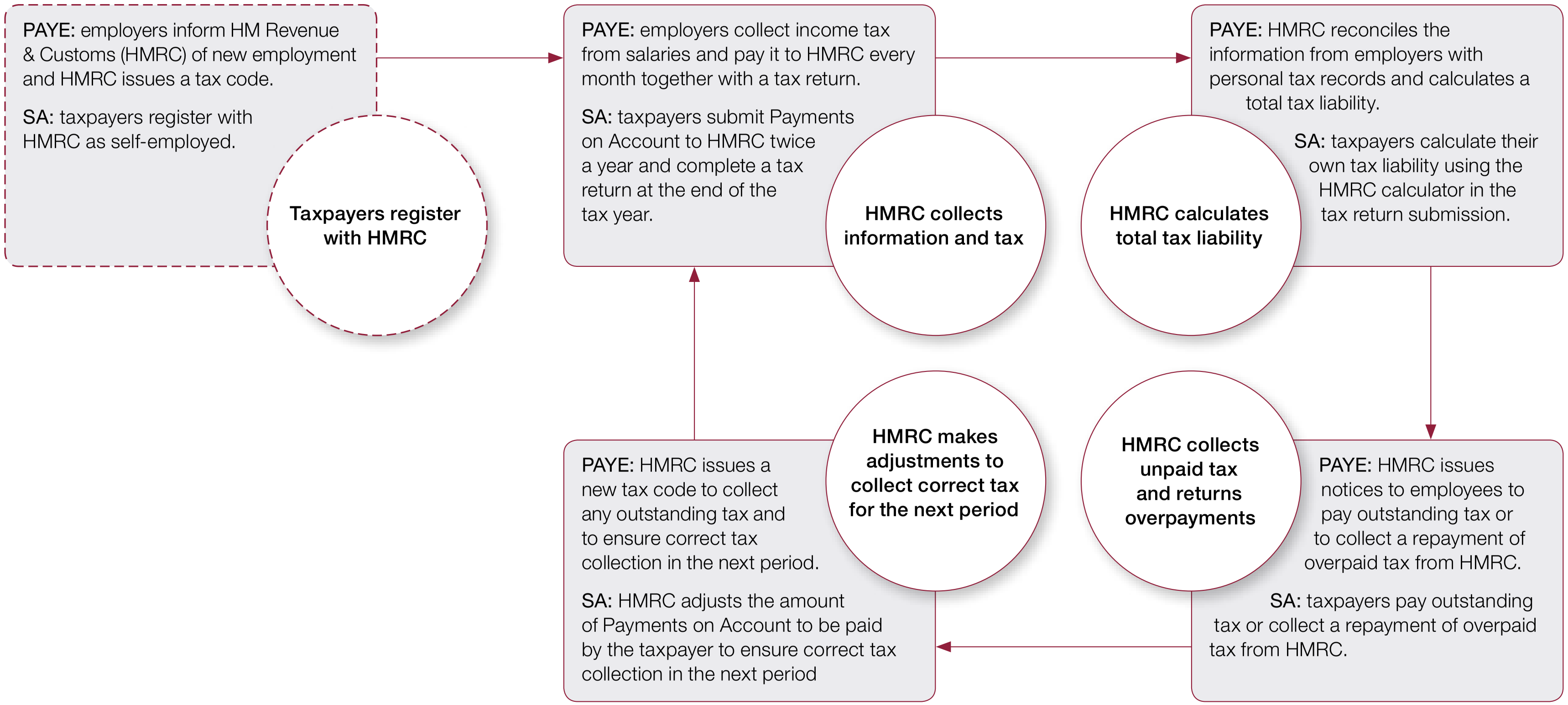
1.5 The PAYE and Self Assessment processes have common principles, despite utilising different IT systems and data sources to assess and collect tax. **Figure 2** overleaf identifies these principles and describes the main processes for each income tax stream.

1 *HM Revenue & Customs 2018-19 Annual Report and Accounts 2018-19*, HC 2394, July 2019.

Figure 2

The income tax system

The Pay As You Earn (PAYE) and Self Assessment 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 An individual taxpayer may also need to register for Self Assessment to report other sources of income.

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

1.6 Taxpayer information is submitted to HMRC through several channels. For PAYE, employers and pension providers complete data submissions containing information about individuals' earnings, pension payments and tax deductions when they pay their employees. Self Assessment taxpayers complete an annual submission containing details of all the income they have received during the tax year.

1.7 The submissions processing systems complete data validation checks and then route the information to the appropriate tax processing system. A matching function identifies the relevant taxpayer record and stores the new data or updates the existing information in the relevant database.

1.8 The tax processing systems consolidates all the available data to produce a total income figure for each taxpayer and calculates the associated income tax liability using the relevant business rules.[2] The output from the income tax liability calculation is then stored on the appropriate taxpayer's record.

1.9 The calculated tax liability is compared with the amounts deducted at source or collected from taxpayers directly through payments on account. The reconciliation determines whether the correct amount of tax has been collected; if tax has been underpaid this will be collected from the taxpayer, or if overpaid will be refunded.

1.10 For PAYE taxpayers, tax codes are recalculated based on the latest tax liability data and, if necessary, HMRC will update the tax code for the forthcoming tax year by issuing a coding notice to the taxpayer and the employer.

Devolved income tax

1.11 The administration of devolved taxes diverges from the UK processes only in 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 Welsh applies the 'C' 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 Welsh, 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 Welsh 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.

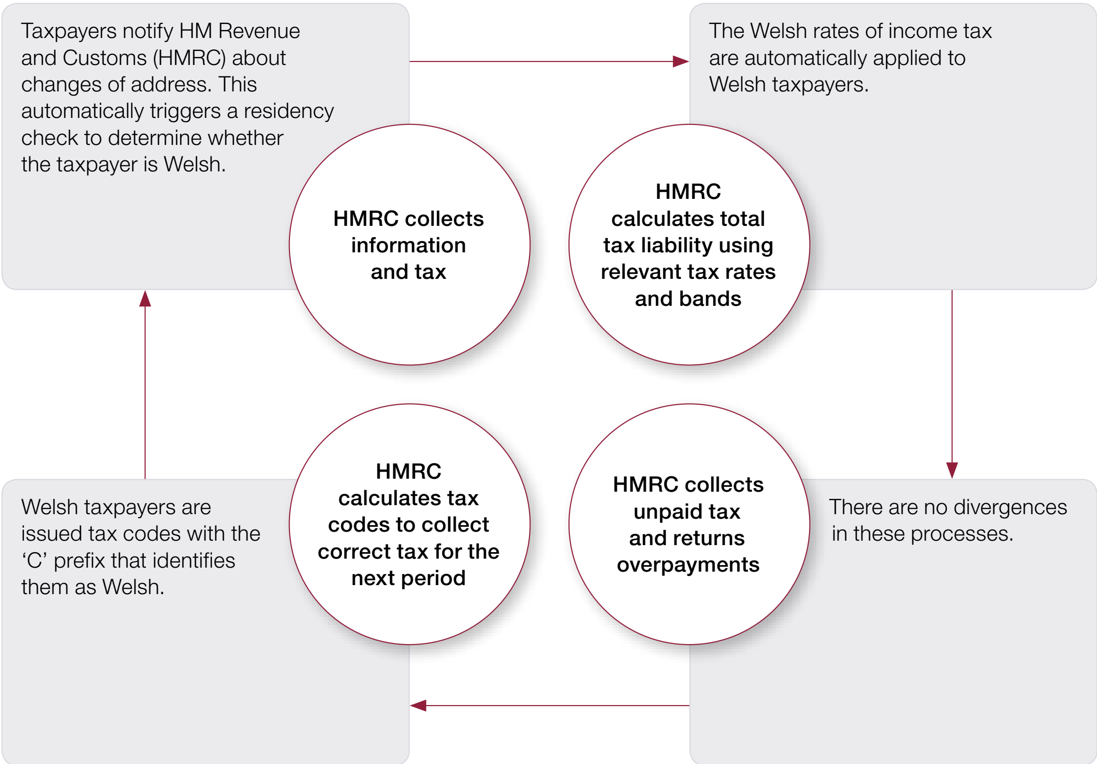
Figure 3 overleaf shows where these divergences occur within the income tax system.

2 Business rules contain data relevant to the calculation of tax liabilities and they are used by each tax processing system to calculate income tax liabilities based on income data. The rules include, but are not limited to, the application of tax codes and the rates and thresholds that apply to each type of income based on residency. Business rules are updated annually to reflect changes in tax policy.

1.12 The correct application of these business rules is dependent upon the completeness and accuracy of address data that HMRC holds for each taxpayer, and the maintenance of a master list of UK addresses that confirms which country they are in.

Figure 3
Divergences in the 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

Assurance of income tax processing

1.13 Our annual programme of audit work in 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.

1.14 To assure the automated system controls we map the system functionality of the income tax cycle and confirm that the automated controls are implemented appropriately. These controls include the:

- processing of data submissions, including basic data format and validation checks;
- transferring of data between systems and ultimately to the correct tax system;
- matching of data to the correct taxpayer record and updating it as necessary; and
- application of the appropriate business rules to the calculation processes for each taxpayer – including their residency status for devolved tax purposes.

1.15 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 the 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 residence; and
- issuing of tax codes for PAYE taxpayers which incorporate residency information to ensure that employers deduct tax under the tax rules of the correct country.

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

1.17 HMRC will publish its first estimate of revenue under the Welsh rates provisions in its Annual Report and Accounts 2019-20, with the outturn calculated in the following year and published in its Annual Report and Accounts 2020-21. In the meantime, the Office for Budget Responsibility (OBR) has estimated that £2.1 billion of tax revenue will be collected relating to Wales in 2019-20.[3]

3 Office for Budget Responsibility, *Devolved Tax and Spending Forecasts*, March 2019, Table 1.4.

1.18 We expect HMRC's methodology for estimating the revenue and calculating the final outturn for Welsh income tax to be consistent with the methodology applied to Scottish income tax.[4] This methodology for estimating the devolved income tax revenue is consistent with the methodology used by the OBR to forecast income tax receipts for Wales, and at the whole-of-UK level. We have previously highlighted the limitations with this approach in our reports on HMRC's administration of Scottish income tax and we expect the same limitations will apply for the Welsh revenue estimate.

1.19 HMRC is working closely with the Welsh Government to ensure that they are in agreement on the methodology used to produce the outturn. In our future reports on Welsh income tax, we will audit the data, methodologies, assumptions and mechanics of the revenue estimate and outturn. Where the calculations rely upon estimation, this work will be planned and completed by applying the principles set out in the International Standards on Auditing (UK) to design audit procedures relevant to the nature of the estimates and to a sufficient level of precision.

4 Comptroller and Auditor General, *Administration of Scottish income tax 2018-19*, Session 2019-20, HC 24, SG/2020/1, National Audit Office, January 2020, paragraphs 1.2–1.28.

Part Two

Progress made in administering the Welsh rates of income tax

2.1 Part Two of this report presents our findings from reviewing the implementation of the Welsh rates of income tax, including key events and timings.

2.2 This part of the report covers HM Revenue & Customs' (HMRC's):

- progress in implementing the Welsh rates of income tax project (paragraphs 2.3 and 2.4);
- governance arrangements for the project (paragraphs 2.5 and 2.6);
- procedures to identify a complete and accurate record of the Welsh taxpayer population (paragraphs 2.7 to 2.25);
- progress in implementing the relief at source project for administering tax relief on pensions contributions (paragraphs 2.26 to 2.28);
- communications with taxpayers and employers (paragraphs 2.29 to 2.35); and
- activity undertaken by HMRC to identify and respond to compliance risks (paragraphs 2.36 to 2.40).

Implementing the Welsh rates of income tax project

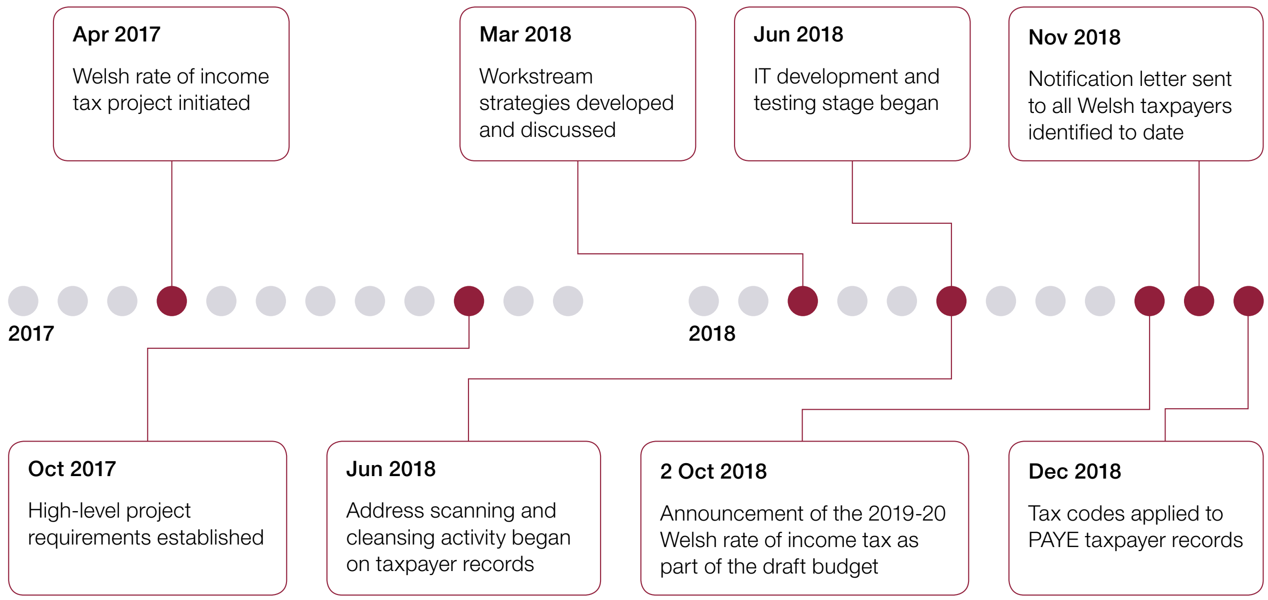
2.3 HMRC implemented the project as scheduled to enable the administration of the Welsh rates of income tax when they took effect from 6 April 2019. Several important project tasks are still to be completed during 2019-20, including the development of digital solutions for Welsh Self Assessment taxpayers and further development of processes for administering tax relief for pension contributions for Welsh taxpayers (**Figure 4** on pages 16 and 17). HMRC expects the remaining project activities to be completed on schedule.

2.4 Further activity may take place beyond 2019-20, for example, the introduction of new legislation relating to tax relief for gift aid may require additional work to implement any changes, although this is subject to agreement between HMRC and the Welsh Government.[5]

5 The Devolved Income Tax Rates (Consequential Amendments) Order 2018.

Figure 4
Welsh rates of income tax: project milestones

The project was initiated and planned in 2017-18. HM Revenue & Customs (HMRC) has implemented those plans in 2018-19 and is continuing to roll out additional elements to the project in 2019-20

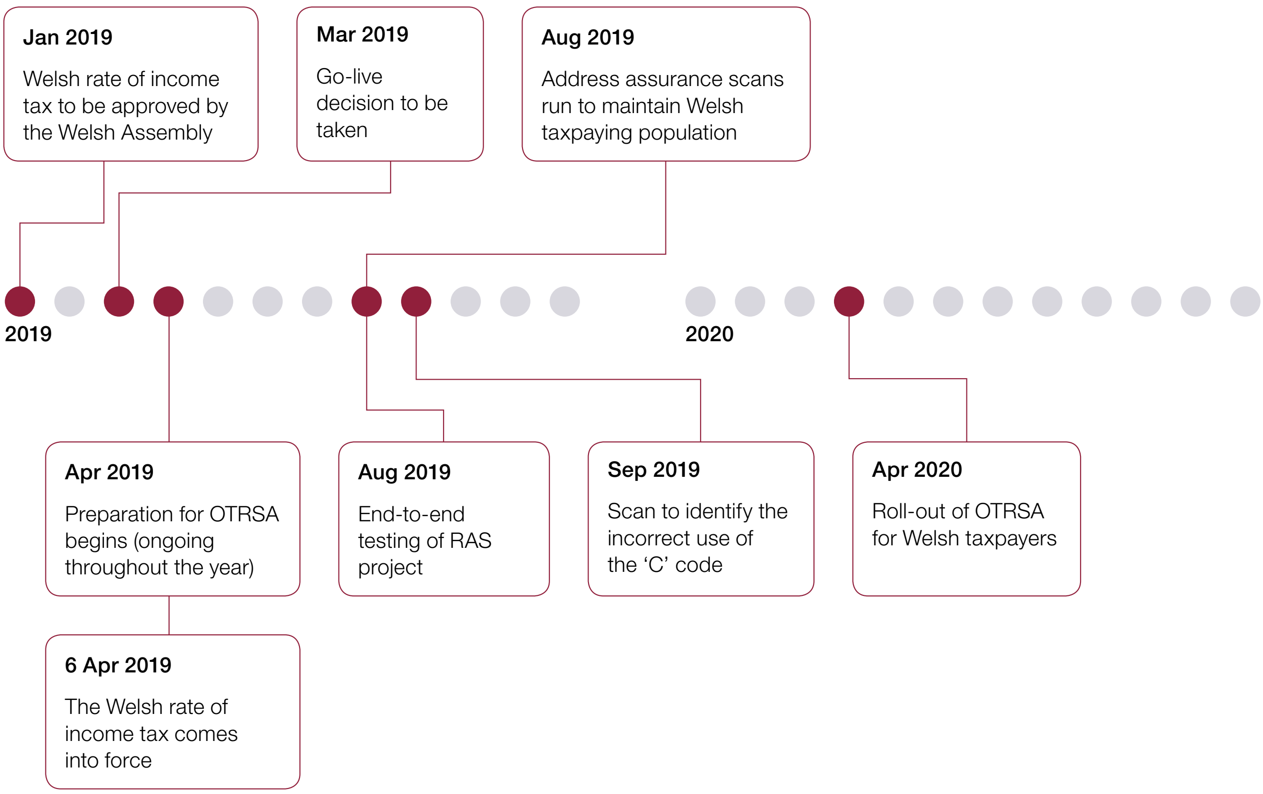


Notes

1 The Relief at Source (RAS) changes made by HMRC bring the Welsh project in line with Scotland.

2 The Online Tax Return Self Assessment (OTRSA) scheme is due to be fully operational by April 2020.

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

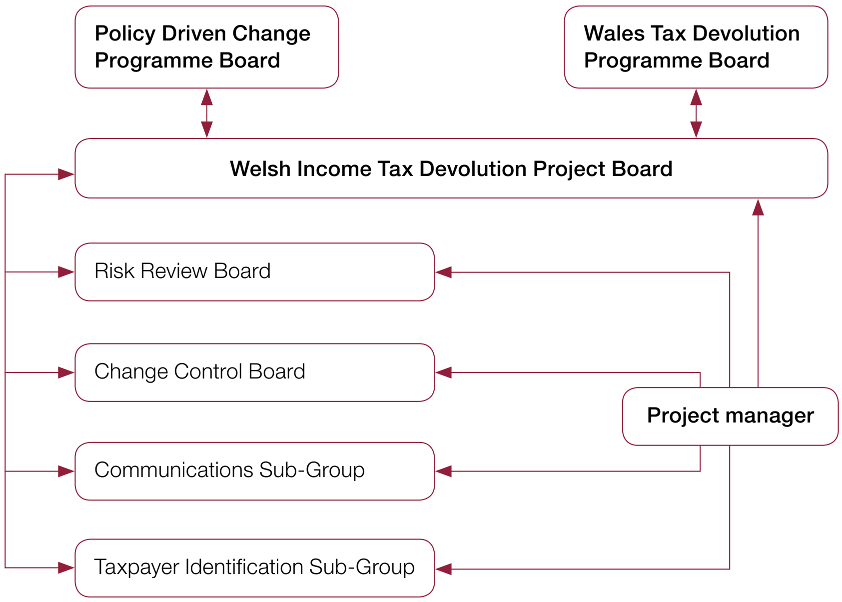

Jan 2019
Welsh rate of income tax to be approved by the Welsh Assembly
Mar 2019
Go-live decision to be taken
Aug 2019
Address assurance scans run to maintain Welsh taxpaying population
2019
2020
Apr 2019
Preparation for OTRSA begins (ongoing throughout the year)
6 Apr 2019
The Welsh rate of income tax comes into force
Aug 2019
End-to-end testing of RAS project
Sep 2019
Scan to identify the incorrect use of the 'C' code
Apr 2020
Roll-out of OTRSA for Welsh taxpayers

Governance arrangements

2.5 HMRC has established a project governance structure within its wider devolution and change programme and it is engaging with Welsh Government representatives across the full range of project activities (**Figure 5**). There is evidence of constructive challenge by Welsh Government officials in these forums, while HMRC has helped joint working by locating some of its project personnel in Cardiff. The Welsh Government is represented throughout the project structure, including boards below the Welsh Income Tax Devolution Project Board.

Figure 5
Governance structure for implementing the Welsh rates of income tax

The Welsh Income Tax Devolution Project Board is a decision-making body responsible for the delivery of the Welsh rates of income tax project, supported by the activities of the lower-level boards and sub-groups



Notes

1 The Wales Tax Devolution Programme Board holds the ultimate decision-making powers for significant issues escalated from the Welsh Income Tax Devolution Project Board for the implementation of the Welsh rate of income tax.

2 The Policy Driven Change Programme Board is primarily a governance and assurance function for change projects within HM Revenue & Customs (HMRC). It holds an oversight role on the activities of the Welsh Income Tax Project Board and also inputs on issues escalated to the Wales Tax Devolution Programme Board.

3 The Risk Review board is chaired by the project manager and is responsible for identifying, assessing, managing and reviewing project risks. Issues that cannot be managed at this level are escalated to the Welsh Income Tax Devolution Project Board.

4 The Change Control Board is chaired by the project director and holds delegated powers from the Welsh Income Tax Devolution Project Board to approve cost proposals funded by the Welsh Government that exceed the Project Manager approval limit of £60,000. Proposals above £250,000 are assessed and escalated to the Welsh Income Tax Devolution Project Board for approval.

5 The Communications Sub-Group and Taxpayer Identification Sub-Group are responsible for designing, developing and implementing detailed plans in their areas of competence. Strategy proposals and significant issues are escalated to the Welsh Income Tax Devolution Project Board for approval.

6 The Taxpayer Identification Sub-Group was not a regular feature of the governance structure following the approval of the taxpayer identification strategy by the Welsh Income Tax Devolution Project Board.

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

2.6 A joint HMRC and Welsh Government review team carried out a project assessment review (PAR) in October 2018. This concluded that the project had made considerable progress in the first six months of 2018-19 and was in a good position to enable ministers of the National Assembly of Wales (the Assembly) to set the Welsh rates of income tax for HMRC to collect from April 2019.

Identifying the Welsh taxpayer population

2.7 A Welsh taxpayer is someone with a tax liability whose main place of residence in a given tax year is Wales, or who spends most of that tax year living in Wales.[6] HMRC is responsible for determining whether someone is a Welsh taxpayer. There are some exceptions whereby a taxpayer would always be deemed Welsh (such as Welsh Assembly Members, Members of the European Parliament (MEPs) representing Welsh constituencies and Welsh Members of Parliament (MPs) sitting in Westminster). **Figure 6** overleaf provides an overview of the rules used to determine residency.

2.8 Based on the latest Income Tax Liabilities Statistics published in June 2019 (which include projections from the 2016-17 *Survey of Personal Incomes*),[7] HMRC estimated that there were 1.4 million taxpayers in Wales in 2018-19.[8] This estimate relates to the number of individuals who had a tax liability.[9]

Identifying Welsh taxpayers

2.9 Identifying the Welsh taxpayer population is the main challenge for HMRC in implementing the Welsh rates of income tax. To ensure that taxpayers are correctly notified of their Welsh status and the right amount of tax is collected from individuals and allocated to the appropriate government, it is essential that address information is correct.

2.10 For the 2019-20 tax year, the overall income tax rates in Wales are consistent with the UK income tax rates, however, it is important that all Welsh taxpayers are identified to ensure that the revenue generated from the Welsh rates is correctly allocated to Wales. Welsh taxpayers are identified by use of the prefix 'C' (for Cymru) in their tax code.

6 This definition therefore excludes individuals who earn less that the Personal Allowance or those, for other reasons, that have income but no tax liability – for instance, because they have claimed a relief that reduces their potential liability to nil or had no taxable income during the year.

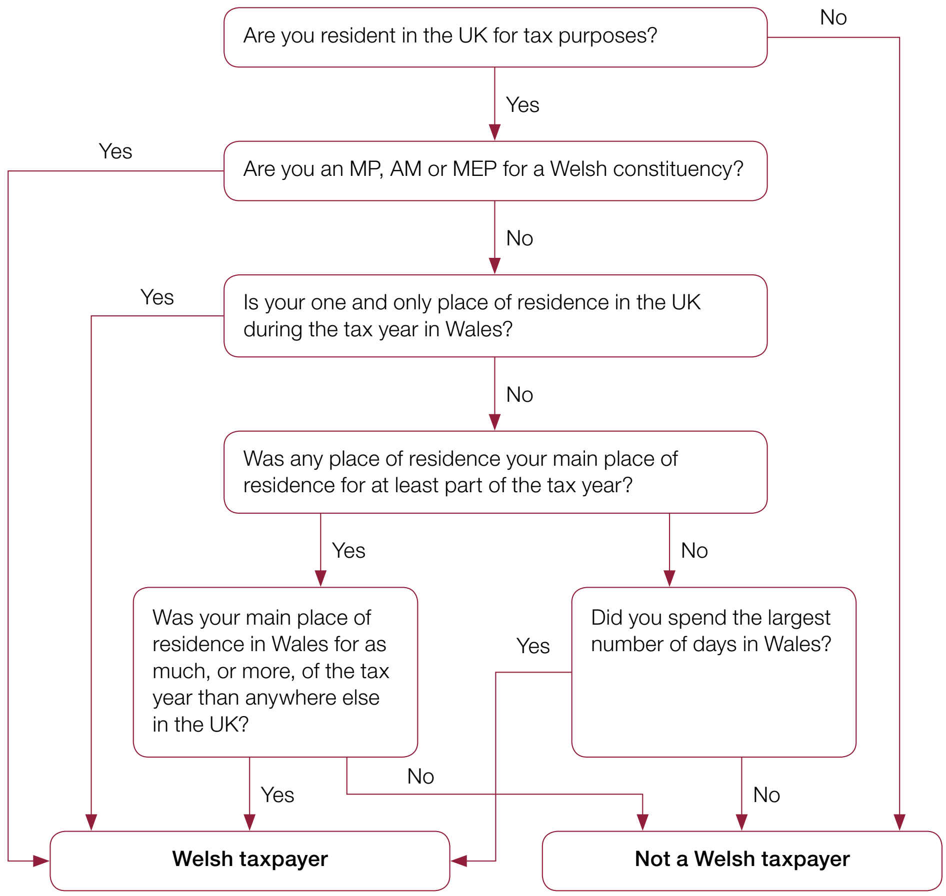
7 The *Survey of Personal Incomes* is based on a sample of information held by HMRC on individuals who could be liable to UK income tax. It is carried out annually by HMRC and covers income assessable to tax for each tax year. The data it gathers are used to construct an evidence base to inform policy analysis, national statistics, tax modelling and forecasting. Although it is reasonably accurate at a UK level, it is less robust for regional analysis because of the sampling methodology it employs.

8 HM Revenue & Customs, *Income tax liabilities statistics: tax year 2016 to 2017 to tax year 2019 to 2020*, HM Revenue & Customs, June 2019, Table 2.2, Number of income taxpayers by country.

9 Projections included in the income tax liabilities statistics (ITLS) publication are made by incorporating known future income tax policy changes and Office for Budget Responsibility (OBR) determinants to the 2016-17 Survey of Personal Incomes data.

Figure 6
Rules for determining Welsh taxpayers

For most people residency rules determine whether or not you are a Welsh taxpayer



Note

1 Welsh Members of Parliament (MPs), Welsh Assembly Members (AMs) and Members of the European Parliament (MEPs) representing Welsh constituencies are always determined to be Welsh taxpayers.

Source: National Audit Office analysis of the Government of Wales Act 2006

2.11 In 2018, HMRC implemented a taxpayer identification strategy which set out three main steps to the initial identification of the Welsh taxpayer population:

- Identify all Welsh addresses and compile a master record of Welsh postcodes using Office for National Statistics (ONS) data and, where necessary, mapping information.
- Cleanse the addresses contained in existing taxpayer records to ensure that they are in a consistent format to facilitate automated processing of residency.
- Update taxpayer records with the appropriate flag when an address is identified as having a Welsh postcode.

2.12 HMRC compared the list of 91,000 live Welsh postcodes from the ONS data, with its Pay As You Earn (PAYE) and Self Assessment taxpayer records to identify an initial population of Welsh taxpayers. The National Insurance and PAYE Service (NPS) includes both PAYE and Self Assessment taxpayers. All taxpayers, both Self Assessment and PAYE, will have a National Insurance record and as such will be included within NPS.

2.13 This initial exercise identified 2.7 million potential Welsh taxpayers based solely on address data. Of the 2.7 million, HMRC issued 2.0 million notification letters to taxpayers who have a live record on NPS. All of the 2.7 million taxpayer records identified with Welsh addresses are flagged on HMRC's systems, so they will automatically pay tax at the Welsh rate if they incur a tax liability.

2.14 In some cases, HMRC holds postcode information which is incomplete, contains errors, or is recorded in the wrong data field on NPS. To help cleanse its records and enable it to identify Welsh taxpayers, HMRC conducted several system scans and identified 36,000 records with:

- incorrect or incomplete postcodes;
- postcode information included in the incorrect field; or
- no postcode information included.

2.15 HMRC has used the findings of the initial address cleansing to enhance the effectiveness of the system scans in the future. For example, HMRC incorporated the results of the initial scans to refine the parameters and further scans conducted in 2019 identified an additional 19,000 records who may be Welsh taxpayers. Of the additional 19,000 records identified, 15,000 were then identified as not currently being in employment or receipt of a pension, and therefore not Welsh taxpayers. HMRC will continue to review and cleanse the address data accordingly to further enhance the accuracy of the information it holds.

2.16 HMRC recognises the key challenge to administering the Welsh rates of income tax is maintaining the accuracy of the Welsh taxpayer population and has commissioned the address cleansing process to be repeated annually. Further cleansing exercises will be used to identify both Welsh and Scottish taxpayers, with the costs shared between both governments.

Cross-border addresses

2.17 In October 2018, HMRC undertook an exercise to review cross-border properties separately. HMRC recognises that individuals living around the Welsh–English border may be more likely to challenge their residency status, with nearly 100 postcodes including some 1,100 properties straddling the border. Using unique property reference and country code data from the Ordnance Survey (OS), together with Geographical Informational Systems (GIS) techniques, HMRC plotted the position of each property within these postcodes to identify those situated in Wales.[10]

2.18 In 34 cases, the border ran through individual properties and, for these, HMRC used a technique called centroid determination to ascertain whether properties were mainly in Wales or England.[11] Following this review, HMRC has manually updated its records to match individual taxpayers to cross-border properties identified as Welsh.[12] Going forward, HMRC will continue to monitor cross-border postcodes and check for any new houses which may be built (and new postcodes assigned).

Maintaining the accuracy of the Welsh taxpayer population

2.19 In December 2018, HMRC commissioned a comparison of the data held in its master record of addresses to those of an independent third-party. This process provides HMRC with assurance that its address data are consistent with third-party data sources. Where records differ these are not updated, as it is possible for either the address held by HMRC or the address within the third-party data source to be incorrect. Where differences were identified which indicate an alternative address to that held by HMRC, and an initial notification letter had not been sent, HMRC contacted the taxpayer to request that they confirm or update their address details.

2.20 Initially, in order to assess the overall level of accuracy of HMRC's address data, all records with a Welsh address were matched to the Royal Mail's Postcode Address File (PAF). Of the 2.7 million Welsh taxpayer records identified, 96.4% of the population were found to have addresses which were consistent with the PAF. Of those that were matched to the PAF, 99.9% were found to have an accurate postcode.

2.21 HMRC's records were matched to other independent data sources such as the electoral roll and credit reference agency listings in order to corroborate the address data held in HMRC's systems. Of the 2.7 million taxpayers identified, 2.2 million were matched to third-party data sources, leaving 0.5 million unmatched records. More information on this can be found in **Figure 7**.

10 A unique property reference number (UPRN) is an alphanumeric number assigned to every spatial address in Great Britain and remains with it for its entire lifecycle; from planning permission to destruction.

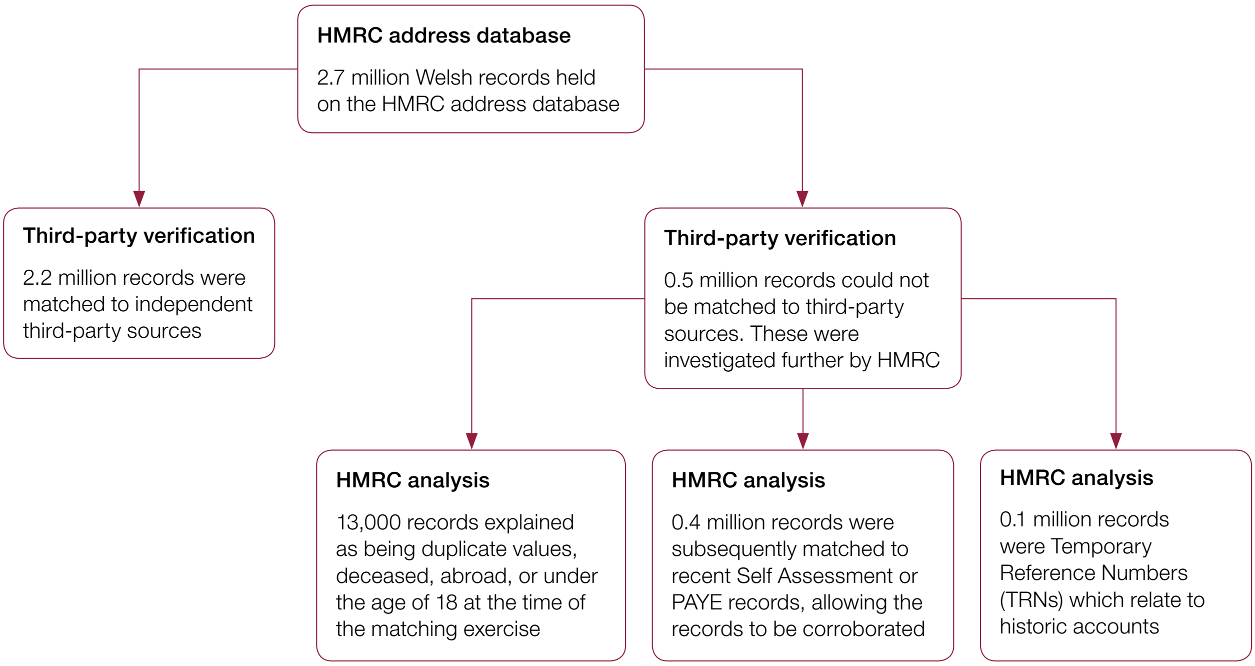
11 Centroid determination is a mathematical concept whereby the central point of a figure is plotted. HMRC plotted this point on cross-border properties. The side of the border the centroid fell within was used to ascertain which side of the border the property fell within.

12 HMRC found 140 cases where a taxpayer could not be matched to a property, but further data-matching has reduced this number significantly.

Figure 7

Summary of the taxpayer data verification exercise

HM Revenue & Customs (HMRC) has corroborated its own data to a number of different data sources



Note

1 Figures presented may not sum due to rounding.

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

2.22 The 0.5 million records which could not be matched were then investigated further by HMRC. Following the review, the majority of these records were either:

- successfully corroborated back to the Self Assessment submission data and employer PAYE records held on HMRC systems;
- found to be duplicated, or relate to taxpayers who were deceased, abroad or under the age of 18; or
- temporary reference numbers (TRNs).[13]

13 A TRN is assigned when submitted data from the taxpayer does not match that on HMRC's system. HMRC has informed us that as such cases have not been matched to the system, these records relate to historic accounts which precede the inception of NPS, which was introduced in 2012-13, or have been superseded by allocating a permanent National Insurance Number (NINO) to the individual.

Welsh parliamentarians

2.23 Welsh parliamentarians are automatically deemed to be Welsh taxpayers in any tax year during which they are in office.[14] This applies to the 60 elected members of the Welsh Assembly along with 40 MPs in Westminster representing a constituency in Wales and four MEPs representing Welsh constituencies.

2.24 HMRC has a manual process in place to identify the records of Welsh parliamentarians to ensure that they are recorded as Welsh taxpayers regardless of their residency. This requires communication of required information to them by employers or from parliamentarians themselves and must be completed annually.

2.25 In response to errors with applying tax codes to Members of the Scottish Parliament (MSPs) in 2019,[15] HMRC has now implemented a weekly process to check the residency status, tax codes issued and tax codes being operated by employers of Welsh parliamentarians, and will again conduct manual processes to identify all Welsh parliamentarians prior to annual coding for 2020-21 tax codes. HMRC intend to continue to review and implement further improvements for handling Welsh parliamentarians, to ensure that their residency status is correctly applied; this includes the implementation of manual processes to review Self Assessment calculations.

Tax relief on pension contributions

2.26 It is important that Welsh taxpayers are identified within each pension scheme by the scheme providers so that tax relief on pension contributions is administered and allocated correctly. HMRC is implementing a consistent system for identifying the residency status of taxpayers across Wales and Scotland. 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.

2.27 To administer relief at source, HMRC requires that all providers submit an annual report in a specified format, listing all member contributions in the previous tax year. HMRC had already developed the procedure for applying tax relief at source in relation to Scottish taxpayers. Those from Wales were added to the existing framework, and final stages of implementation conducted simultaneously. Since April 2019 it has been mandatory for pension providers to use HMRC's online Secure Data Exchange Service (SDES) to submit returns. Returns should be received by HMRC by July each year and an Annual Notification of Residency Report is issued to the providers via SDES the January following the return each year.

14 The Government of Wales Act 2006, as amended by the Wales Act 2014.
15 Comptroller and Auditor General, *Administration of Scottish Income Tax 2018-19*, Session 2019-20, Session 2019-20, HC 24, SG/2020/1, National Audit Office, January 2020, paragraphs 2.30-2.33.

2.28 HMRC is in the process of introducing automatic processing of the residency status of scheme members. This will utilise the temporary process already in place for Scottish taxpayers to trace the scheme members submitted to HMRC and notify pension providers of the residency status of their members.

Communication with taxpayers and employers

2.29 HMRC's Welsh Income Tax Devolution Project Board approved a communications strategy in March 2018 which incorporated high-level plans to target internal and external audiences to make them aware of the changes that would take place as a result of the implementation of the Welsh rates of income tax and the steps to take. The Project Assurance Review, completed in October 2018, also considered the communications strategy and recommended strengthening external engagement, stakeholder and communications planning and leadership. HMRC has responded to these findings by preparing stakeholder mapping and external communications plans and clarifying responsibilities (**Figure 8** overleaf).

2.30 In November 2018, HMRC issued 2.0 million bilingual notification letters to individuals identified as Welsh taxpayers following initial identification work. These letters help HMRC to further refine the information it holds, inviting taxpayers to provide updated information where appropriate and offering links to further information on the Welsh rates of income tax. Each letter also includes a flyer from the Welsh Government.

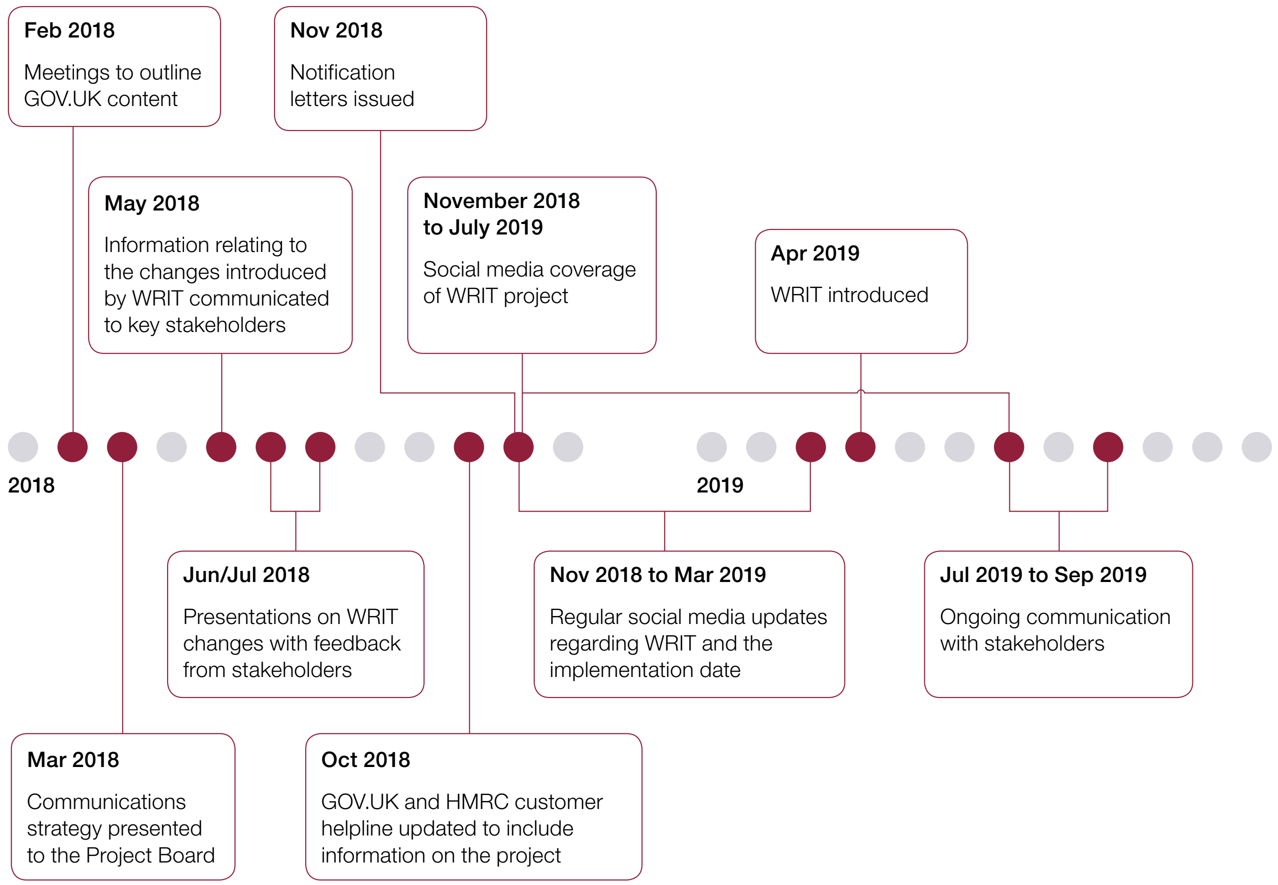
2.31 In 2017-18 we reported that when the notification letters were issued in November 2018,[16] there were still 10,000 known addresses which had not been cleansed. The issuing of the notification letters was a one-off process. For the 10,000 taxpayer records still awaiting address cleansing, and any additional Welsh taxpayers identified after November 2018, HMRC would issue a standard coding notice with the Welsh tax code present in addition to the Welsh tax now being liable if income was sufficient to pay tax.

16 Comptroller and Auditor General, *Administration of Welsh income tax 2017-18*, Session 2017–2019, HC 1869, National Audit Office, January 2019.

Figure 8

Summary of key communication milestones for the implementation of the Welsh rates of income tax project

HM Revenue & Customs (HMRC) has communicated with its key stakeholders throughout the project



Note

1 WRIT references relate to the Welsh rates of income tax project.

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

Employer application of Welsh 'C' tax code

2.32 HMRC issues tax code notices to all employers to apply the 'C' tax code for all Welsh taxpayers who have been identified.

2.33 In learning from the experience on Scotland, HMRC had always planned to run a scan in June to compare the information held on HMRC systems with employer data. HMRC identified that it had correctly issued the 'C' codes to employers, however, the June scan revealed that 174,000 individuals had the incorrect tax code attributed to them by their employer or pension provider. This was caused by a combination of factors including:

- an error within the payroll software used by some employers, meaning that the 'S' code was applied signifying a Scottish status rather than Welsh. HMRC were initially alerted to this issue after the first payroll run at the end of April 2019;
- those who submit quarterly returns and had not filed up to June meaning the most recent tax code would have been from the last return of the prior tax year; and
- employers not applying the 'C' code.

2.34 HMRC worked with the employers most affected by this issue through regular meetings, employer bulletins and phone calls to ensure the correct tax codes were being applied on the employers' systems. In September 2019, HMRC repeated the scan, which found that 57,000 employees had the incorrect tax code.

2.35 Where employers are operating an incorrect tax code, there is a risk that the wrong amount of tax is deducted through PAYE. At the end of the tax year, HMRC will use the Welsh tax code held in their records to calculate the tax and will determine whether or not the correct amount of tax has been deducted through the PAYE reconciliation process.

Compliance risk assessment and planning

2.36 HMRC applies risk-based compliance activity 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.[17]

17 HM Revenue & Customs, *Tackling tax avoidance, evasion, and other forms of noncompliance*, March 2019.

2.37 HMRC considers compliance risk annually through its UK-wide Strategic Picture of Risk (SPR) assessment. HMRC applies a customer group segmentation approach to assess the compliance risks for each group at the UK-wide level. HMRC's enforcement and compliance activities are targeted at the most significant risks within each customer group. HMRC considers the main areas of risk to Welsh income tax to be compliance risks which are tackled at the whole-of-UK level:

- 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.

2.38 HMRC considers that there is currently minimal risk of individuals falsifying their residency status, given the lack of divergence in Welsh rates at this time. HMRC's assessment is that all risks relating to Wales are the same as those which apply to the rest of the UK and are covered by their central compliance strategy.

2.39 HMRC has developed bespoke activity designed to support the administration of devolved income tax, this includes:

- making changes to the Self Assessment online system which require individuals to declare their residency status on their return;[18]
- building address change functionality into taxpayers' personal tax accounts, helping to ensure that the address database is kept up to date; and
- continuing to work with large employers to help prevent, identify and respond to identified issues.

2.40 HMRC recognises that the compliance risks arising from the Welsh rates of income tax could change in future should the income tax rate in Wales diverge from the rest of the UK (excluding Scotland). In the future, we expect HMRC to perform a specific risk assessment for Wales and consult with the Welsh Government in accordance with the Memorandum of Understanding.

18 The paper return uses slightly different questions but asks taxpayers to confirm both their address and residency status. For both paper and online tax returns, HMRC uses the records held on the system as the basis for calculation.

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 latter 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 A supporting framework sets out the principles for identifying net additional costs. HMRC recharges costs that can be validated as specifically related 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 2018-19

3.4 In 2018-19, HMRC incurred and recharged £5.8 million in costs relating to the implementation of Welsh income tax.

3.5 We examined HMRC's method for estimating the costs of collecting and administering the Welsh rates of income tax for the year, to ensure that this was reasonable in the context of the agreement with the Welsh Government. Based on our procedures, we have concluded that the amount repaid by the Welsh Government for the year ended 31 March 2019 is accurate and fair.

Project costs to date

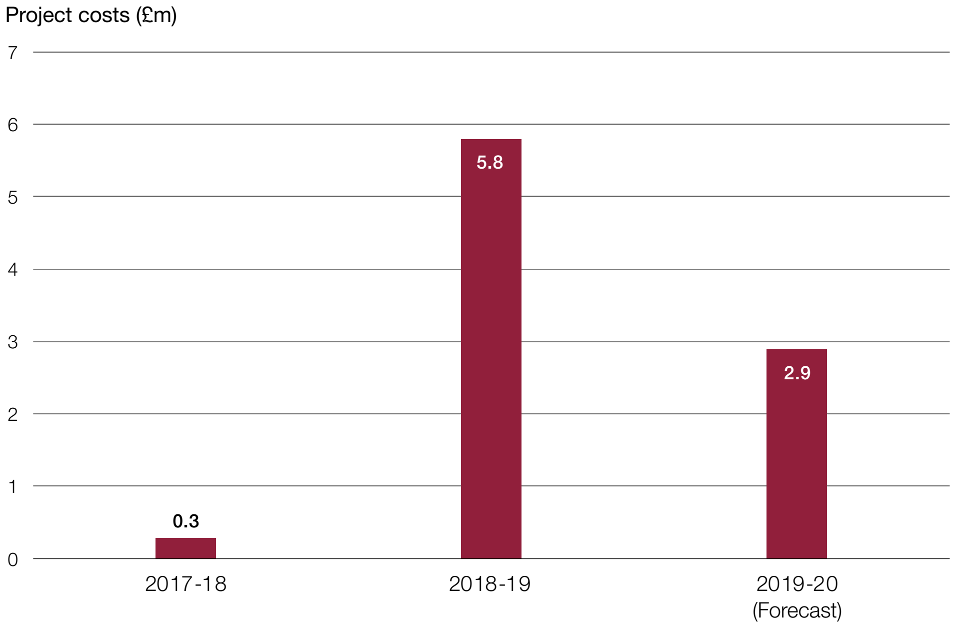
3.6 HMRC has estimated that the overall cost of implementing the Welsh rates of Income tax and the relief at source (RAS) project to be between £7.5 million and £9.5 million. This relates to the implementation of the project and not the running costs associated with administering the Welsh rates of income tax and RAS. The forecast has been refined as a result of the lessons learnt from implementing the Scottish rate of income tax.

3.7 HMRC is monitoring the costs through its project risk management processes. Up to the year ending 2018-19 HMRC has spent £6.1 million on implementing the Welsh rates of income tax and RAS. HMRC estimates the remaining implementation costs in 2019-20 will be £2.9 million (**Figure 9**).

Figure 9

Actual and forecast project implementation costs for the Welsh rates of income tax project from 2017-18 to 2019-20

Spending incurred to date relates to implementation costs



Notes

1 Costs are for the Welsh rate of income tax project and relief at source (RAS) projects.

2 2019-20 figures are reported based on HM Revenue & Customs (HMRC) forecasts as at July 2019. This includes £2.1 million relating to the Welsh rates of income tax and £0.8 million relating to RAS costs.

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 2018-19, 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 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.

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

5 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 HMRC.

6 This document review has been supplemented by semi-structured interviews with HMRC staff in a number of areas of the business.

7 We reached our findings following our analysis of evidence collected between May and October 2019.

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