National Audit Office

Administration of Welsh rates of income tax 2020-21

HM Revenue & Customs

REPORT

by the Comptroller and Auditor General

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Administration of Welsh rates of income tax 2020-21

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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Key facts

1.3m
Welsh taxpayers in 2019-20

£2,041m
Welsh rates of income tax revenue in 2019-20

£2,110m
HM Revenue & Customs' estimate of the Welsh rates of income tax revenue in 2020-21

£0.7 million Costs of administering Welsh income tax in 2020-21

Summary

Introduction

Welsh income tax

1 The Wales Act 2016 gave the Senedd full power to determine the rates (excluding the personal allowance) paid by Welsh taxpayers on all non-savings, non-dividend income, from 6 April 2017. The Welsh Government receives all income tax revenue generated from non-savings, non-dividend income under Welsh income tax policy.

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). For 2020-21, 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).

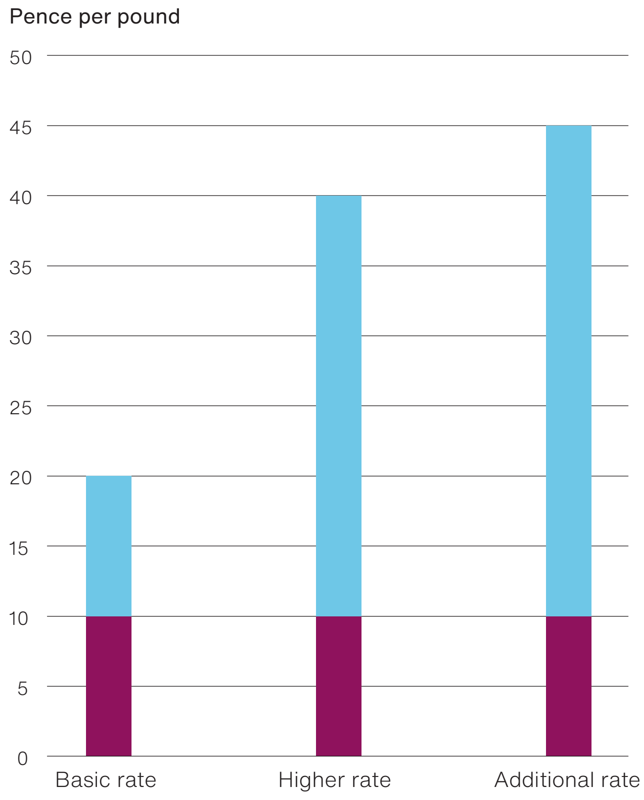
Roles and responsibilities

3 HM Revenue & Customs (HMRC) administers and collects Welsh income tax as part of the UK tax system. HMRC identifies taxpayers living in Wales by applying a ‘flag’ in its systems that indicates they are subject to Welsh income tax rates. HM Treasury is responsible for paying Welsh income tax to the Welsh Government.

4 Following the end of each tax year, HMRC produces a provisional estimate of Welsh income tax revenue for that year. The final outturn is calculated the following year once HMRC receives further information from taxpayers and employers. This report covers the final outturn for 2019-20 and the provisional outturn for 2020-21. HMRC expects to publish the outturn for 2020-21 in its 2021-22 Annual Report and Accounts.

Figure 1
Welsh rates of income tax for 2020-21

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 2020-21, 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

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 amounts reimbursed to HMRC as administrative expenses.

6 This report considers:

- HMRC's calculation of the 2019-20 income tax revenue for Wales, the 'outturn', and assurance on the correctness of amounts brought to account (Part One);
- HMRC's estimate of the 2020-21 income tax revenue for Wales and our view on the estimate methodology (Part One);
- key controls operated by HMRC to assess and collect 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 the accuracy and fairness of these amounts in the context of costs incurred by HMRC (Part Three).

7 Appendix One sets out our audit approach and methodology.

Key findings

Welsh income tax 2019-20 final outturn and 2020-21 estimate

8 HMRC calculated the final outturn for 2019-20 as £2,041 million, representing amounts collected under Welsh income tax policy. HMRC's estimate of Wales's 2019-20 income tax revenue, published in September 2020, was £2,008 million, meaning the actual outturn was £33 million higher than HMRC had originally estimated. We examined the methodology to calculate the actual outturn, which necessarily includes remaining areas of estimation. In these areas, we evaluated the basis of HMRC's estimate including relevant assumptions and available data. Based on that audit work, we concluded the Welsh income tax revenue outturn for 2019-20 is fairly stated (paragraphs 1.2 to 1.16).

9 **HMRC has estimated Welsh income tax revenue for 2020-21 as £2,110 million.** This represents an increase of £69 million (3.4%) against the 2019-20 outturn. Despite the impact of public health restrictions arising from COVID-19 on the economy and HMRC compliance activity, income tax revenues remained stable because growth in wages and salaries was stronger than anticipated. HMRC expects to calculate the finalised 2020-21 income tax outturn attributable to Wales in 2022. The estimate HMRC produces is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Welsh Government (paragraphs 1.17 to 1.21).

10 **The impact of COVID-19 on both the economy and individual taxpayers increases the level of uncertainty in HMRC's estimate of Welsh income tax revenue in 2020-21.** HMRC identified the collectability of tax revenues as the key source of uncertainty and took account of this as part of its normal calibration to outturn adjustment. We consider the approach adopted by HMRC to estimating the impact of COVID-19 on Welsh income tax revenue in 2020-21 to be reasonable (paragraph 1.22).

Administration of Welsh rates of income tax

11 **HMRC has adequate rules and procedures in place to ensure the proper assessment and collection of Welsh income tax and those rules are being complied with**. Our work on Welsh income tax matters builds on our wider assessment of HMRC's rules and procedures, completed as part of our annual audit of HMRC. As part of that audit, 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 (paragraph 2.2 to 2.13).

12 **Maintaining an accurate and complete record of the 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. We found that there had been an increase in the number of missing Welsh postcodes identified by HMRC's address cleansing work, with 30,473 identified compared to 17,371 when we last reported. This continues to represent a small proportion (around 2%) of the overall taxpayer population with HMRC having investigated and updated all identified cases where individuals were either employed or receiving a pension (paragraph 2.14 to 2.24).

13 **HMRC continues to assess the risk of non-compliance in relation to Welsh income tax as low because there is no divergence between Welsh tax rates and the rest of the UK.** In 2020-21, HMRC produced a Welsh Strategic Picture of Risk (SPR). It 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 (paragraphs 2.25 to 2.26).

14 HMRC calculated a compliance yield of £100 million relating to Wales for 2019-20, 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. HMRC also estimates the Welsh share of net losses was £280 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 (paragraphs 2.26 to 2.27).

15 HMRC has limited performance data available about its compliance activities in Wales. Unlike its income tax system which flags residents as Welsh, HMRC's compliance system cannot readily identify people living in Wales. HMRC therefore cannot easily track and monitor compliance activity in Wales and this affects its ability to collect performance data about the extent of Welsh non-compliance (paragraph 2.29).

16 COVID-19 has continued to have an impact on HMRC's compliance and debt management activities. Across the UK, there were 29% fewer civil compliance cases opened and 26% fewer cases closed in 2020-21 than in 2019-20, which reduces the level of tax receipts that HMRC has collected through its compliance activities. Our recent report *Managing tax debt through the pandemic* found that the debt balance for income tax across the UK increased from £11 billion at the end of 2019-20 to more than £16 billion at the end of 2020-21. An analysis of income tax debt attributable to Wales is not currently available (paragraph 2.30 to 2.33).

Costs

17 In 2020-21 HMRC incurred and recharged £0.7 million of costs to the Welsh Government for the cost of implementing and administering Welsh income tax. We examined HMRC's method for estimating the costs of implementing, collecting and administering Welsh income tax for the year ended 31 March 2021. 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. The 2020-21 costs were lower than in 2019-20, largely because the costs of implementing the Welsh Income Tax Project reduced by £1.2 million. In 2019-20 HMRC recharged costs of £2 million, comprising £1.4 million of implementation costs and £0.6 million of operating costs (paragraph 3.4 to 3.5 and Figure 8).

Part One

Income tax collected from Welsh taxpayers

1.1 Part One of this report covers HM Revenue & Customs' (HMRC's) calculation of the final revenue outturn for Welsh income tax in 2019-20 and its provisional estimate of Welsh income tax revenue for 2020-21. This includes:

- our assessment of HMRC's Welsh income tax outturn calculation for 2019-20, including data limitations and HMRC's judgements in areas of uncertainty; and
- our views on HMRC's estimate of Welsh income tax revenue for 2020-21 and the features and limitations of HMRC's methodology.

The Welsh income tax 2019-20 final outturn

1.2 HMRC's calculation of the outturn for Welsh income tax revenue for 2019-20 is £2,041 million (**Figure 2**). HMRC calculates the final outturn figure from several components, which are aggregated to produce the total Welsh income tax liability for 2019-20. Each component is calculated using one or more sources of data to extract total Welsh income tax liability. HMRC's previous estimate of 2019-20 Welsh income tax, published in November 2020, was £2,008 million, meaning the actual outturn was £33 million (1.6%) higher than the estimated amount.

1.3 The outturn calculation is largely based on established tax liabilities, some £2,100 million, where HMRC has finalised the tax owed and fully reconciled the taxpayer records. The established liabilities are calculated from the final tax liability data extracted from the Pay As You Earn (PAYE) and Self Assessment income tax systems.

1.4 Adjustments or estimates are made where tax due has not yet been finalised, or where HMRC must estimate the Welsh share of uncollectable amounts or tax reliefs. The reduction in Welsh income tax outturn arising from these adjustments was £58 million (net) (Figure 2). In some areas of the calculation, data are not available in sufficient detail to identify income tax liabilities, reliefs or other adjustments relating to individual taxpayers. HMRC estimated the Welsh share of these balances by using other available data, such as population and income data, to apportion the balance between Wales and the rest of the UK.

Figure 2

HM Revenue & Customs' (HMRC's) calculation of the 2019-20 Welsh income tax revenue outturn

The majority of the outturn is based on established liabilities with a small proportion estimated by HMRC

	Amounts based on established taxpayer liabilities	Amounts based on estimated liabilities and adjustments	Total
	(£m)	(£m)	(£m)
Self Assessment established liabilities[1]	633	(12)	620
PAYE established liabilities[1]	1,467	(6)	1,461
Estimated further liabilities[2]	–	45	45
Deductions from revenue[3]	–	(85)	(85)
Total	**2,100**	**(58)**	**2,041**

Notes

1 Self Assessment and Pay As You Earn (PAYE) established tax liabilities are based primarily on the tax liability data held by HMRC, although some amounts are based on estimates as well.

2 This is HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future Self Assessment returns or compliance activity.

3 Deductions from revenue include tax relief on pension contributions and Gift Aid.

4 Totals do not sum due to rounding.

Source: HM Revenue & Customs, *Annual Report and Accounts 2020-21*, HC 696, November 2021; HM Revenue & Customs, *Welsh Income Tax Outturn Statistics: 2019 to 2020*, July 2021; and National Audit Office analysis of HM Revenue & Customs data

1.5 The methodology used to calculate the 2019-20 outturn for Welsh income tax was discussed by HMRC and the Welsh Government at the Welsh Rates of Income Tax Board in May 2021 and formal agreement was received from the Welsh Government in the same month.

1.6 We examined the methodology for the outturn calculation, which necessarily includes some remaining areas of estimation. In these areas, we evaluated the basis for HMRC's estimate including relevant assumptions and available data. Based on our procedures, we conclude the Welsh income tax revenue outturn for 2019-20 is fairly stated. The key components of the calculation of outturn are described in more detail below.

Self Assessment established liability

1.7 The Self Assessment established liability of £633 million represents the calculation of all income tax attributable to Wales from Welsh Self Assessment taxpayers in 2019-20. The calculation of Self Assessment liabilities is mainly based on the extraction of Welsh taxpayer data from HMRC's systems but with some apportionment of other balances.

1.8 HMRC identifies Welsh taxpayers using a 'Welsh indicator flag' in its 'Computerised Environment for Self Assessment' (CESA) system. It can identify total Welsh income tax liabilities by extracting Welsh taxpayer records from CESA. HMRC has also made minor adjustments to apportion Wales's share of other relevant Self Assessment balances where specific data are not available.[1]

PAYE established liability

1.9 The PAYE established liability of £1,467 million represents the sum of all income tax attributable to Wales from Welsh PAYE taxpayers in 2019-20. While most PAYE liabilities are based on extracting Welsh taxpayer data from HMRC's systems, some apportionment of other smaller elements is required.

1.10 Under PAYE, employers submit data monthly to HMRC on the earnings and tax deductions made for their employees and this information is recorded in HMRC's National Insurance and PAYE Service (NPS) system. HMRC identifies Welsh taxpayers in the NPS using a residency indicator based on taxpayer postcode information. By extracting Welsh taxpayer records from the NPS, HMRC can identify the total Welsh income tax liabilities. HMRC deducts an estimate of the Welsh share of tax reliefs given against PAYE liabilities.

1.11 An adjustment is made to apportion the tax collected from employers under PAYE settlement agreements.[2] The Welsh share calculated for 2019-20 was £4.2 million. As tax liabilities are settled through one payment for the employer, the identity of individual taxpayers is not recorded and therefore HMRC undertakes an analysis of employer submissions to determine the Welsh proportion of UK-wide settlement agreement revenue. PAYE settlement agreement returns from employers were not all received in line with the expected timetable due to COVID-19. HMRC estimated the value of agreements due based on historic trends and the agreements already in place with employers.

1 This includes an estimate of £3 million from manually entered liabilities and assessments, which do not provide a split of the liability between taxes. It also includes sensitive records, which are not accessed by HMRC to calculate the Welsh share of income tax. An estimate of £15 million deducted for the Welsh share of tax reliefs claimed through Self Assessment was also made.

2 A PAYE settlement agreement allows employers to make one annual payment to cover all tax due on minor, irregular or impracticable expenses or benefits for employees in the scheme.

Estimated further liabilities

1.12 Most Self Assessment liabilities for 2019-20 are established prior to calculating the outturn. Nevertheless, HMRC knows from past years that Self Assessment tax liabilities will continue to be established and collected for up to six years afterwards. This is because HMRC continues to receive additional information from taxpayers and through its compliance activity. The estimated additional liability for these elements is calculated based on past performance and is valued at £43 million in the 2019-20 outturn. An estimated adjustment of £1.5 million is also made in relation to further PAYE liabilities that have not yet been determined, such as where year-end totals or information about benefits-in-kind received by the taxpayer is still outstanding.

Deductions from revenue

1.13 HMRC makes a series of deductions from the outturn revenue, recognising that not all taxpayer liabilities will be collected in practice. It uses historical information to calculate these deductions and apportions an amount for Welsh taxpayers.

1.14 Some PAYE and Self Assessment income tax liabilities are never settled because either employers or taxpayers fail to pay the full amounts due. HMRC has analysed historical data for all the UK to determine patterns of uncollected liabilities and then apportioned an amount relating to Welsh taxpayers. This was calculated to be £21 million for 2019-20.

1.15 Further deductions are made for pension contributions and Gift Aid, both of which attract income tax relief at the taxpayer's marginal rate of income tax. Pension scheme administrators claim tax relief at the basic rate from HMRC on behalf of their scheme members, while charities claim tax relief at the basic rate from HMRC on behalf of their donors. HMRC calculated both deductions by estimating the Welsh share of each tax relief claimed across the UK using historical data. The Gift Aid deduction was calculated to be £27 million for 2019-20 and pension contributions £38 million.

Impact of COVID-19 on the revenue outturn

1.16 HMRC undertook specific work to consider the impact of COVID-19 on the outturn for 2019-20 and identified the collectability of tax revenues as the key risk. HMRC undertook less compliance activity in 2020-21 and therefore recorded fewer losses, which it does not think is representative of future years. HMRC accounted for this in the calculation of the outturn by using 2019-20 rather than 2020-21 collection data because it deemed that this was a better proxy for likely collection rates in the future. More information on the impact of COVID-19 on HMRC's compliance activities can be found at paragraphs 2.25 to 2.34.

The Welsh income tax estimate for 2020-21

1.17 HMRC estimates it will collect £2,110 million of Welsh income tax revenue relating to the 2020-21 year.[3] This represents an increase of £69 million (3.4%) against the 2019-20 outturn. Despite the impact of public health restrictions arising from COVID-19, income tax revenues in both Wales and the rest of the UK performed better than expected because growth in wages and salaries was stronger than anticipated. The final outturn for the 2020-21 year is expected to be published in HMRC's 2021-22 Annual Report and Accounts. The estimate produced by HMRC is solely for financial reporting purposes in its annual accounts and does not affect the amount of revenue ultimately received by the Welsh Government.

1.18 HMRC's methodology to estimate Welsh income tax revenue for 2020-21 is based on taxpayer data from 2018-19, extracted from its Survey of Personal Incomes. Wales's percentage share of the overall UK income tax liability is determined through analysing data in a model replicating the UK income tax system known as the Personal Tax Model. The data are adjusted to reflect demographic and policy changes that are expected or known to have taken place between 2018-19 and 2020-21. The share is then applied to the total UK tax liability to produce an estimate of revenue for Welsh income tax (**Figure 3**).

1.19 In line with the approach for Scottish income tax, HMRC made a 'calibration' adjustment to the Welsh revenue estimate because its methodology has historically resulted in actual outturn being lower than estimated outturn. HMRC made this adjustment by comparing the 2019-20 outturn with a revised estimate of 2019-20 revenue using the same methodology but with the most recent assumptions and data. The impact of the calibration adjustment reduced the 2020-21 provisional estimate by £0.1 billion (3.0%) (see Figure 3).

1.20 The calibration adjustment is subject to the following limitations:

- It assumes the 2020-21 over-estimation would be consistent with the over-estimation observed in 2019-20 in percentage terms.
- The causes of the over-estimate in 2019-20 are not fully understood and any socioeconomic factors contributing to it may be different in 2020-21.

3 HM Revenue & Customs, *Annual Report and Accounts 2020-21*, HC 696, October 2021.

Figure 3

Method for calculating the Welsh 2020-21 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 2018-19.[1]

→

Personal Tax Model

HMRC calculated the percentage share of UK income tax that related to Welsh taxpayers to be 1.19%.

→

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 1.20%.

→

Total UK income tax liability 2020-21

HMRC combined Self Assessment liabilities[2] with PAYE receipts to calculate the total liability[3] for the UK of £182.8 billion.

→

Total Welsh income tax liability 2020-21

HMRC applied the previously calculated Welsh share to the total income tax liability. The estimate of Welsh income tax calculated was £2.2 billion.[4]

→

Calibrated 2020-21 Welsh Revenue Estimate

HMRC calculated an overall calibration adjustment of 3.0% to reflect that historically the actual outturn has been lower than the initially estimated amount from this methodology. The calibrated estimate is £2.1 billion.[5]

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 2020-21, adjusting for differing rates of population growth and economic factors such as wage increases, to calculate the Welsh share.

2 Non-savings, non-dividend income only.

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

4 HMRC applied the previously calculated Welsh share to the total income tax liability before Gift Aid, and then removed the estimated share of Welsh Gift Aid along with other much smaller adjustments.

5 The calibration adjustment for Wales is calculated on a band-by-band basis. When compared with the outturn, the basic rate adjustment was calculated to be 2.7%, the additional rate 3.6% and the higher rate 9.4%. When looked at in totality, the band-by-band adjustments result in a 3.0% difference between the 2019-20 outturn and revised estimate.

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

1.21 Our review concluded that HMRC's approach is reasonable. However, the limitations we described in previous reports relating to HMRC's methodology for estimating Welsh income tax revenue remain relevant for 2020-21:

- The use of sample data introduces sampling uncertainty into the revenue estimate 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.
- An assumption must be made around the volume and value of under- and over-payments relating to PAYE liabilities.

1.22 The impact of COVID-19 on both the economy and individual taxpayers increases the level of uncertainty in HMRC's estimate of Welsh income tax revenue. HMRC identified the collectability of tax revenues as the key source of uncertainty and took account of this as part of its normal calibration to outturn adjustment. We consider the approach adopted by HMRC to be reasonable.

Part Two

Administering Welsh income tax

2.1 This part of the report covers:

- HM Revenue & Customs' (HMRC's) key processes to administer the income tax system and our approach to obtaining assurance on them (paragraphs 2.5 to 2.13);
- HMRC's procedures to identify and maintain a complete and accurate record of the Welsh taxpayer population (paragraphs 2.14 to 2.24); and
- HMRC's activity to identify and respond to compliance risks (paragraphs 2.25 to 2.34).

2.2 HMRC uses the same systems to administer income tax whether it is received from a taxpayer in Wales or the rest of the UK. However, HMRC also operates additional rules and procedures for Wales, and we assess these below. This reflects HMRC's responsibility to administer income tax for Welsh taxpayers in the same way as the service provided elsewhere in the UK.

2.3 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General (C&AG) must consider the adequacy of HMRC's systems to assess and collect tax in the UK, including income tax. Each year we publish a report (the Standard Report) alongside HMRC's Annual Report and Accounts setting out the C&AG's conclusions in this respect. Our 2020-21 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.

2.4 To support the conclusions of this report, we extend our UK-wide testing to address divergences due to devolution. We also undertake specific procedures looking at HMRC's address-cleansing and wider tax compliance activities. These inform our assessment of the completeness and accuracy of HMRC's Welsh income tax estimates. To reach our conclusions, we examine several elements of devolved tax administration, such as the ongoing maintenance of Welsh taxpayer records, and how devolved tax compliance risks were identified and responded to.

The income tax system

2.5 HMRC's system to collect income tax is consistent across the UK. Depending on the type of income an individual receives, income tax is assessed and collected by employers deducting earnings through Pay As You Earn (PAYE), by the taxpayer submitting a Self Assessment return, or both.

2.6 The PAYE and Self Assessment processes share common principles, despite using different IT systems and data sources to assess and collect tax. **Figure 4** identifies these principles and describes the main processes for each income tax stream.

Assurance of income tax processing

2.7 Our annual audit work programme on HMRC includes procedures providing assurance over key tax processing controls. These controls are 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.

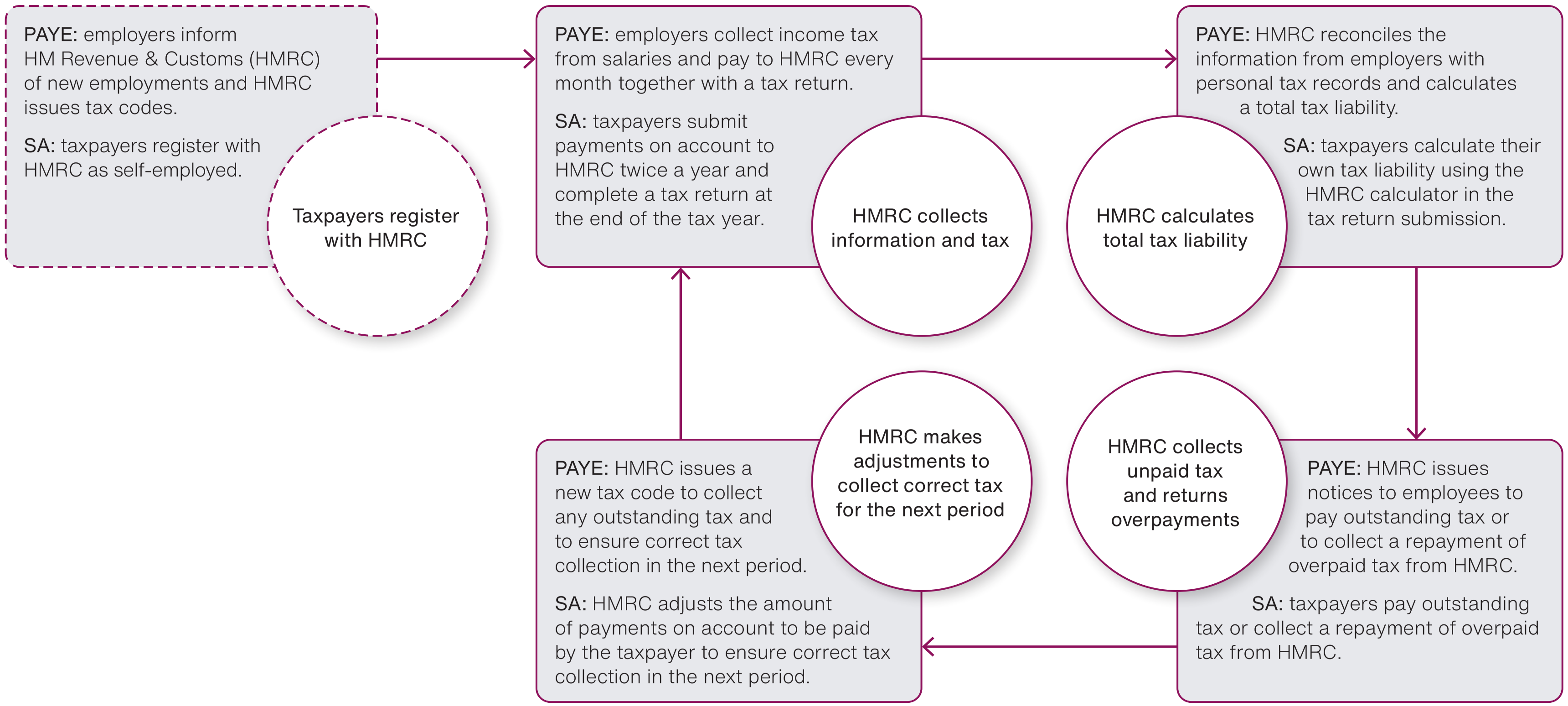
2.8 Following annual updates to business rules to reflect changing tax rates, thresholds, and allowances for the UK and devolved administrations, HMRC completes several phases of assurance testing on key business controls to confirm system functionality. We evaluate the scope of this testing and re-perform elements to confirm HMRC's conclusions as part of our audit. The key processes in PAYE include annual:

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

2.9 Similar processes are applied to each individual Self Assessment return that HMRC receives. Self Assessment taxpayers make payments on account and at the year-end calculate their own tax liability using HMRC's calculator in the tax return submission.

Figure 4
The 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

Devolved income tax

2.10 The main differences in administering devolved taxes, when compared to UK processes, are the business rules the system applies when completing tax liability and tax code calculations. There have been no significant changes to system rules since our last report covering 2019-20. The rules applied for Welsh taxpayers are:

- The system checks the individual's residency status and applies the 'C' tax code prefix where they are identified as a Welsh resident. This instructs employers to collect tax under Welsh tax rates. Where an individual is no longer resident in Wales, the 'C' prefix is removed.
- Where an individual is identified as a Welsh resident, Welsh tax rates and bands 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 is enrolled on a PAYE scheme, the system uses Welsh income tax rates to calculate a new tax code for the following year.

2.11 Self Assessment returns include a check box for the taxpayer to state whether they resided in Wales. If this contradicts HMRC's records, HMRC uses the address it holds to calculate the taxpayer's tax liability. Taxpayers are notified of the discrepancy and asked to update their address if required. **Figure 5** shows where these divergences occur within the income tax system.

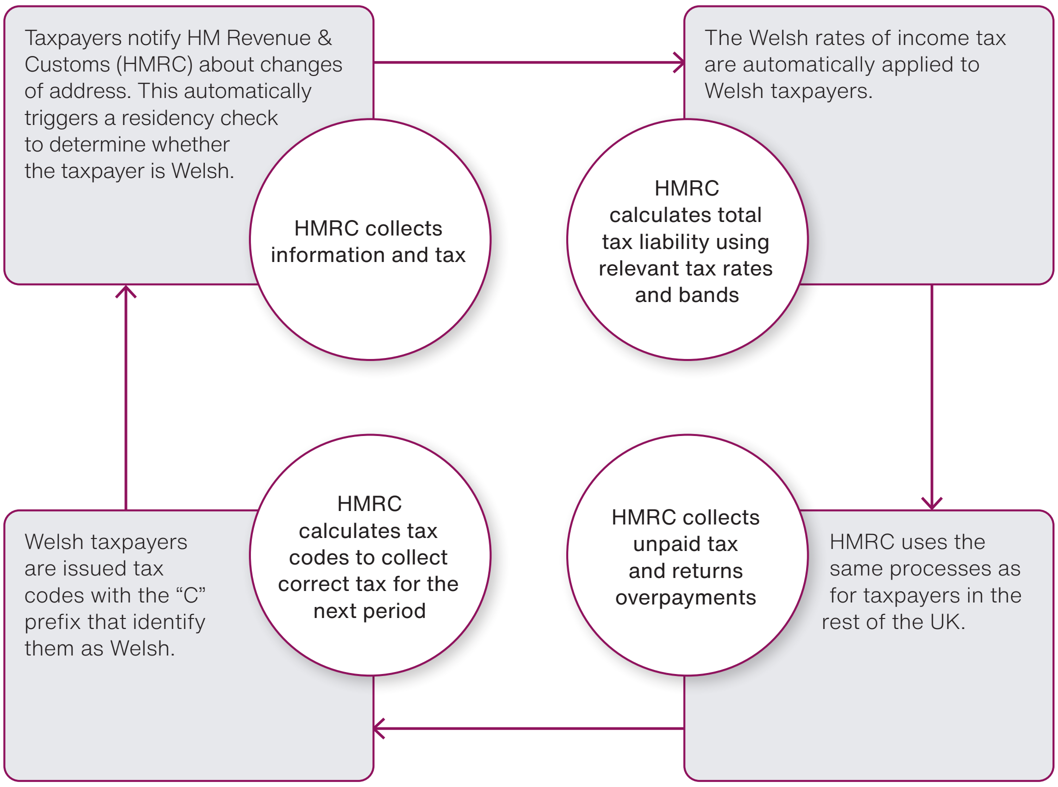
Tax relief on pension contributions

2.12 Welsh taxpayers must be identified within pension schemes so that tax relief is correctly allocated. Pension administrators claim tax relief at source on behalf of their members and add this to their members' contributions. HMRC's Relief at Source (RAS) system automatically confirms the residency status of pension scheme members to ensure the correct relief is applied at source. It applies tax relief on pension contributions at the basic rate of 20% for all taxpayers. Welsh taxpayers paying a tax rate above 20% can claim the remaining tax relief through a Self Assessment return or by contacting HMRC.

2.13 To administer relief at source, HMRC requires all pension providers to submit an annual report listing their members' contributions during the previous tax year. HMRC's systems automatically trace scheme members and match them against addresses held to identify Welsh taxpayers. An Annual Notification of Residency Report is then issued to all pension providers. HMRC confirmed the residency status for 92% of Scottish and Welsh pension scheme members following the 2019-20 tax year and provisionally estimates that 94% have been confirmed following the 2020-21 tax year. Following the 2019-20 tax year, HMRC issued Annual Notification of Residency Reports to pension scheme providers in January 2021.

Figure 5
Divergences in the income tax system for Welsh taxpayers

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



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

Welsh taxpayer population

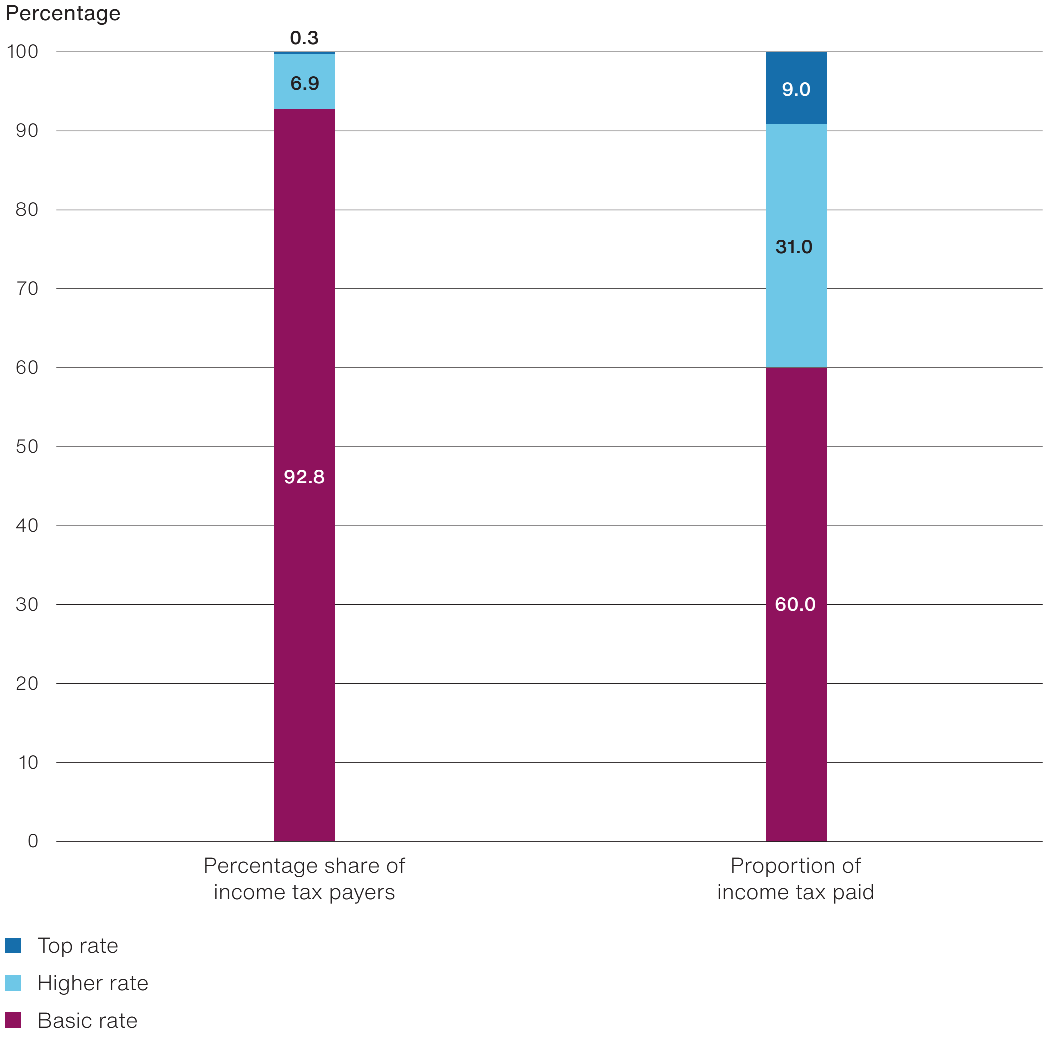
2.14 HMRC has calculated there were 1.3 million Welsh taxpayers in 2019-20.[4] A Welsh taxpayer is someone with a tax liability whose main place of residence during the tax year is Wales. Welsh parliamentarians are also deemed Welsh taxpayers. Higher-rate and top rate taxpayers accounted for just over 7% of the Welsh income tax payer population in 2019-20 but contributed around 40% of income tax paid. Basic rate taxpayers accounted for 93% of the population and provided 60% of tax paid (**Figure 6** overleaf).

4 HM Revenue & Customs, *Welsh Income Tax Outturn Statistics: 2019 to 2020*, July 2021.

Figure 6

Proportions of income tax payers and income tax paid by band in Wales, 2019-20

Higher-rate and top rate income tax payers accounted for 7% of the population but contributed 40% of the income tax paid



Note

1 2019-20 is the latest year for which data are available.

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

2.15 Maintaining accurate and complete records of the Welsh taxpayer population continues to be the main challenge for HMRC in administering Welsh income tax. HMRC has many information sources for changes of address but relies primarily on taxpayers informing it of such changes on a timely basis, although taxpayers are not legally required to do this. HMRC also obtains address information from other sources such as employers, though it is not mandatory for employers to provide updates when their employees' addresses change.

2.16 Address information must be correct to ensure the right amount of tax is collected from individuals and allocated to the appropriate government. HMRC has several assurance processes in place to maintain the completeness and accuracy of the address data it uses to identify Welsh taxpayers (**Figure 7** overleaf).

Postcode scans

2.17 HMRC scans taxpayer records to identify missing or invalid postcodes which would result in an incorrect residency status being applied. The most recent scan performed in September 2020 identified 30,473 missing postcodes, of which 1,636 were updated. This compares with 17,371 missing postcodes when we last reported, of which 2,047 were subsequently updated. Numbers of missing postcodes increased over the previous year but still represent a very small proportion (around 2%) of the 1.3 million Welsh income tax payer population. HMRC investigates and updates identified cases where individuals were either employed or receiving a pension. Cases not updated are identified as dormant because they have no current taxable income.

The administration of Welsh tax codes

2.18 Where an employer does not apply the 'C' prefix to an employee's tax code, they will deduct tax at the UK rate. HMRC reconciles what each taxpayer has paid in tax against what it thinks they should have paid at the end of the tax year. HMRC then uses this finalised information and the residency status held on its systems to calculate the tax liability each taxpayer should pay. The outturn for Wales is, therefore, unaffected where the 'C' prefix in an individual's tax code is not correctly applied by an employer.

2.19 Each month, HMRC compares tax codes in PAYE submissions with its own taxpayer record to identify cases where employers are using a different tax code. The number of cases where the correct 'C' prefix was not being operated varies across the year. In May 2020, HMRC identified 43,257 Welsh taxpayer records (3.3% of cases) where employers were not operating a tax code with a 'C' prefix. In March 2021, there were 47,818 cases (2.6% of cases). We noted in previous reports that HMRC lacks a target for how low the number of missing 'C' prefixes would be before it considers its compliance activity has been successful.

Figure 7

Assurance over the Welsh taxpayer population

HM Revenue & Customs (HMRC) carries out several assurance activities 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	Comparison of HMRC's list of Welsh postcodes with Office for National Statistics (ONS) data to ensure postcodes are up to date.	Postcode data are received quarterly from the ONS. There were 660 new postcodes added in 2020-21.
Address cleansing	Scans of taxpayer records held by HMRC to identify missing or invalid postcodes which would result in an incorrect residency status being applied.	Scans undertaken in September 2020 identified 30,473 missing postcodes. Of these, 1,636 cases were updated because they had a record of current employment or pension. The remaining records were not updated because no employment was listed. HMRC also identified 22,994 invalid postcodes and updated 4,707 taxpayer records where there was a record of current employment or pension.[1]
Cross-border postcodes	HMRC's systems flag address changes where new addresses lie in a postcode that crosses the England-Wales border. HMRC reviews these cases to ensure the correct residency is determined.	This process has been in place since October 2019. In 2020-21, 473 cross-border cases were reviewed, of which 76 were amended following investigation.
Missing residency flags	Scans to identify Welsh taxpayer records that are not flagged as such in the system.	Scans undertaken during 2020 identified 1,031 cases, all of which were updated.
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.	In March 2021 there were 47,818 cases identified where 'C' prefixes were not correctly applied to tax codes.[2]
Controls to identify incorrect addresses held by HMRC		
Third-party data comparison	A comparison of taxpayer address records held by HMRC with third-party data sources to identify cases where HMRC records are inconsistent with third-party data.	HMRC and the Welsh Government have agreed to run this exercise every two years. The most recent one was completed in April 2021 and compared 2.9 million address records. HMRC identified 9,273 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data. We will report further on the results in our 2021-22 report.
High net worth individuals	HMRC performs checks and procedures to review the movements of high net worth individuals and ensure their addresses are up to date.	

Notes

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

2 Figures are from HMRC's analysis of monthly tax code scans and show the number of tax codes where the Welsh 'C' prefix was not correctly applied, and where the tax code would have otherwise been correct.

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

2.20 When HMRC identifies an employer is not using the correct tax code, it issues a P6 notification to the employer asking them to update the employee's tax code. HMRC carries out work targeting employers making persistent errors and works with them to implement the correct tax code. HMRC were unable to tell us how many employers are repeatedly using the incorrect tax code.

Third-party data exercise

2.21 HMRC periodically compares the Welsh taxpayer address records it holds with third-party data to identify differences. This comparison is HMRC's main source of assurance over its address information and it previously agreed with the Welsh Government to run the exercise every two years. The most recent one concluded in April 2021 and compared 2.9 million Welsh addresses.

2.22 HMRC identified 9,273 records where the residency determined from the address held by HMRC did not match the residency suggested by third-party data. Letters were sent to all affected taxpayers asking them to confirm their address. HMRC are continuing to assess the outcome of the third-party exercise and we will report on this in more detail in our 2021-22 report.

Welsh parliamentarians

2.23 Welsh parliamentarians are automatically deemed as Welsh taxpayers in any tax year they are in office. This applies to the 60 elected members of the Welsh Parliament (MSs) and the 40 members of Parliament in Westminster representing a constituency in Wales.

2.24 Records for Welsh parliamentarians are not processed using normal business rules. HMRC previously used a manual process to identify these records and ensure they were recorded as Welsh taxpayers regardless of residency. This required employers or parliamentarians to provide the required information to HMRC and was completed annually. System changes designed to remove the need to annually update parliamentarians' records were introduced in August 2020. HMRC told us that they did not identify any issues in relation to Welsh parliamentarians' tax during 2020-21.

Compliance risk assessment and planning

2.25 HMRC applies the same risk-based compliance approach to collect income tax in Wales as it does in the rest of the UK. This approach involves:

- **promoting** compliance by designing processes to encourage and help customers get things right first time;
- **preventing** non-compliance through process design and customer insight and providing an opportunity to correct mistakes; and
- **responding**, investigating and correcting compliance risks using tailored activity when intervention is needed.

2.26 As part of its Service Level Agreement with the Welsh Government, HMRC produces an annual Welsh Strategic Picture of Risk (SPR) to assess and plan for compliance risks applicable to Wales. For the Welsh SPR, HMRC considers key compliance risks at the overall UK level and applies a value to represent the Welsh proportion of these risks. This value is in line with Wales's share of UK income tax in the Welsh Income Tax Outturn Statistics. As with previous years, HMRC has not identified any significant risks specific to Wales and considers the main risks to Welsh income tax are the same as for the whole of the UK. These risks include:

- evasion, where individuals or businesses deliberately omit, conceal or misrepresent information to reduce their tax liabilities;
- the hidden economy, where taxable income is not declared or where declared income is deliberately understated; and
- tax avoidance, where tax rules are exploited to gain a tax advantage that Parliament never intended.

2.27 HMRC measures the effectiveness of its enforcement and compliance activities through compliance yield, its estimate of the additional revenues it considers it has generated and the losses it has prevented. HMRC estimates a compliance yield of £100 million in 2019-20 for the risks in the SPR relating to Wales. It also estimates Wales's share of net losses from these risks was £280 million. HMRC does not consider geographical variation between Wales and the rest of the UK when assessing compliance risk or the relative success of compliance activity.

2.28 The tax gap is the difference between the amount of tax that should be paid and what is actually paid. HMRC does not currently produce a Welsh specific tax gap. In response to a report by the Public Accounts Committee, HMRC noted that calculating a Welsh specific tax gap would be difficult due to methodological reasons and the high degree of uncertainty of such an analysis.[5]

2.29 HMRC has limited information on specific compliance activity undertaken in Wales. It told us that information about numbers of active compliance cases could be commissioned but would require interrogating separate information systems. Unlike the income tax system which can flag Welsh residents, HMRC's compliance system cannot readily identify people living in Wales as the systems are based around risk not individuals. It is therefore challenging for HMRC to collect useful performance data about the extent of Welsh non-compliance.

5 HM Treasury, *Treasury Minutes: Government responses to the Committee of Public Accounts on 'Tackling the tax gap, Twentieth Report of Session 2019–2021'*, January 2021.

Impact of COVID-19 on HMRC's compliance activity and debt management

2.30 The impact of COVID-19, and HMRC's response to it, affected its core compliance activity in 2020-21 and will reduce the level of tax receipts that HMRC has collected through its compliance activities. Across the UK, there were 29% fewer civil compliance cases opened and 26% fewer cases closed in 2020-21 than in 2019-20, partly due to:

- HMRC's ability to visit its customers was limited because many of its staff were required to work from home, there were travel and social distancing restrictions and many businesses were not operating.
- Some staff were reallocated from compliance work to support other COVID-19 measures during the year.
- HMRC said it carried out its compliance activity in a way that recognised the needs and challenges that businesses and individuals were facing.

2.31 Our Standard Report on the HM Revenue & Customs 2020-21 Accounts includes further detail on the impact of COVID-19 on compliance activity and HMRC's work more generally.

2.32 Our report *Managing tax debt through the pandemic* provides detail on how HMRC changed its debt management work in response to the pandemic.[6] HMRC's management of tax debt will affect how much income tax that is initially unpaid is subsequently collected across the UK, including in Wales.

2.33 In responding to the pandemic, HMRC paused most of its debt collection activity and created new employment support schemes to provide grants to employers and self-employed people to help protect jobs. We found that the debt balances for both PAYE and Self Assessment income tax were higher in 2020-21 than they were before the pandemic, and while both balances were reducing by March 2021, they had not fallen to pre-pandemic levels. The combined debt balance for PAYE and Self Assessment income tax at the whole of UK level was almost £11 billion at the end of 2019-20 and more than £16 billion by the end of 2020-21. An analysis of income tax debt attributable to Wales is not currently available.[7]

2.34 Having completed our additional work on devolved tax issues, we are satisfied HMRC has adequate rules and procedures in place to assess and collect Welsh income tax and that these are being complied with.

6 Comptroller and Auditor General, *Managing tax debt through the pandemic*, Session 2021-22, HC 799, National Audit Office, November 2021.

7 In January 2020, before the pandemic had affected tax debt, the UK debt balance for PAYE income tax debt was just below £4 billion, by April 2020 it had increased to £10 billion and continued to increase, reaching almost £13 billion in May, but by March 2021 it had reduced to around £8 billion. UK Self Assessment income tax increased from £4 billion in January 2020 to £5 billion at the start of 2020-21, it continued to increase to around £12 billion in August, then began reducing and was around £8 billion by March 2021 (all values are reported in 2021-22 prices).

Part Three

Costs

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

3.2 Under the Service Level Agreement between HM Revenue & Customs (HMRC) and the Welsh Government, the Welsh Government must reimburse HMRC for net additional costs incurred through administering 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 administering devolved Welsh income tax powers and not the costs of administering the overall income tax system in Wales.

Costs incurred in 2020-21

3.4 HMRC invoiced the Welsh Government for £0.7 million of costs relating to the implementation and administration of Welsh income tax in 2020-21. Of this amount, £0.5 million related to running costs and £0.2 million related to implementation expenses (**Figure 8**). The 2020-21 costs were lower than in 2019-20, largely because the costs of implementing the Welsh Income Tax Project reduced by £1.2 million. In 2019-20 HMRC recharged costs of £2 million, comprising £1.4 million of implementation costs and £0.6 million of operating costs.

3.5 We examined HMRC's method for estimating the costs to collect and administer Welsh income tax for the year ended 31 March 2021. Based on our audit work, we concluded the amount paid by the Welsh Government was accurate and fair in the context of the agreement between HMRC and the Welsh Government.

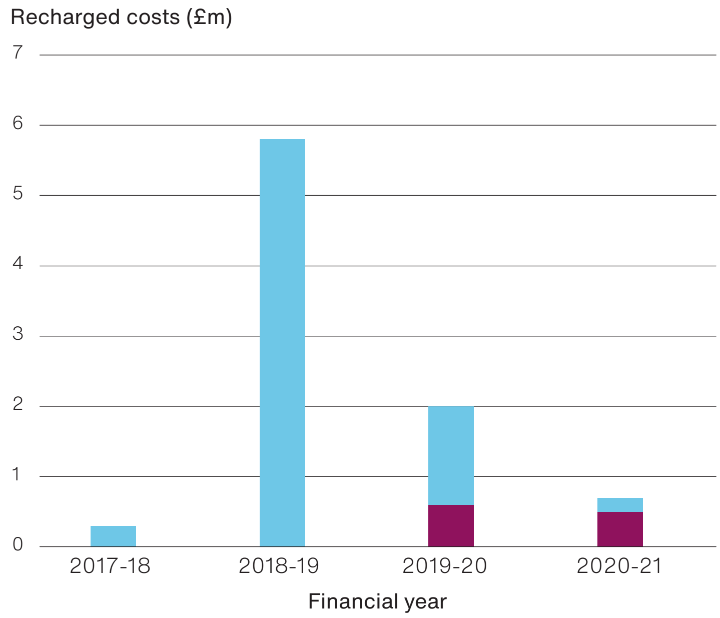
Project costs to date

3.6 HMRC has estimated the overall cost of implementing Welsh income tax to be between £8 million and £9 million. Total expenditure in implementing the project is £7.7 million. The Welsh rates of income tax implementation project has now closed.

Figure 8

Actual spending on Welsh income tax projects from 2017-18 to 2020-21

Spending during the 2020-21 financial year relates to operating and implementation costs



	2017-18	2018-19	2019-20	2020-21
Operating costs	0	0	0.6	0.5
Implementation costs	0.3	5.8	1.4	0.2

Note

1 Implementation costs in 2020-21 relate to the Annual Tax Summary (ATS) and the Welsh Rates of Income Tax project closure.

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

Appendix One

Our audit approach

1 Section 80HA of the Wales Act 1998, as amended by the Finance 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 rate provisions, for the purpose of ensuring the proper assessment and collection of income tax charged at rates determined under those provisions;
- whether these rules and procedures are being complied with;
- the correctness of the sums brought to account by HMRC which relate to income tax which is attributable to a Welsh rate resolution; and
- the accuracy and fairness of the amounts which are reimbursed to HMRC as administrative expenses.

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

3 We audited the data, methodologies, assumptions and mechanics of the calculation for the revenue outturn for 2019-20 and the revenue estimate for 2020-21, and which are described in this report. For the estimate, and where appropriate for the outturn, this work was planned and completed by applying 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 HMRC charged to the Welsh Government is based upon evaluating costs against the details of the Service Level Agreement and supporting framework for costs agreed between both parties. HMRC estimated some of the incurred costs from available data on customer contacts and staff time. During the audit, we saw evidence that both parties regularly discuss and review cost budgets and forecasts as well as agreeing any amounts to be invoiced and paid.

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

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

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

8 We reached our findings following analysis of evidence collected between May and November 2021.

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