

Gasoline, Diesel-fuel, and Tobacco Tax

Background

The Ontario Ministry of Revenue (Ministry) collects the province's commodity taxes on tobacco, gasoline, and diesel fuel under the authority of the *Tobacco Tax Act*, *Gasoline Tax Act*, and *Fuel Tax Act* respectively.

In the 2007/08 fiscal year, taxes collected under these three acts totalled \$4.3 billion, as detailed in Figure 1, and accounted for about 6.2% of the province's total taxation revenue from all sources that year.

As was the case at the time of our last audit in 2001, the Ministry has for reasons of administrative efficiency designated manufacturers and certain large wholesalers as tax collectors, responsible for collecting and remitting to the Ministry the applicable amount of commodity tax. These collectors generally charge tax on sales to organizations or persons who don't have collector status, and they also pay and remit tax on products they themselves consume. As a result, the vast majority of commodity taxes are collected and remitted to the province by relatively few collectors:

- 97% of gasoline tax is remitted by 21 collectors;
- 96% of diesel tax is remitted by 12 collectors;
- and

Figure 1: Commodity Tax Revenues for the Year Ended March 31, 2008 (\$ million)

Source of data: Ministry of Revenue

tobacco tax	1,133.11
gasoline tax	2,438.17
diesel fuel tax	736.70
Total	4,307.98

- 97% of tobacco tax is remitted by 56 collectors.

Sales between designated collectors are generally tax-exempt.

Designated collectors, importers, exporters, and transporters of tobacco, gasoline, and diesel must file monthly returns—in a form required by the Minister—that include:

- information about production, imports, and exports of the applicable commodity;
- listings that detail tax-exempt sales to, and purchases from, other designated collectors; and
- listings that detail the total amount of taxable sales.

Properly completed returns provide the Ministry with the underlying information it needs in order to establish the correct amount of taxes to be paid.

Audit Objective and Scope

The objective of our audit was to assess whether the Ministry had adequate and cost-effective policies and procedures in place to ensure that the correct amount of tobacco, gasoline, and diesel-fuel tax is collected and paid to the province in accordance with the law.

The scope of our audit work included a review and analysis of relevant ministry files and administrative policies and procedures, as well as interviews with appropriate ministry staff. We also talked to, and obtained information from, representatives of the Canadian Convenience Stores Association, the OPP, the RCMP, the Canadian Border Services Agency, and a major cigarette manufacturer.

Our work emphasized the policies and procedures in place with respect to gasoline-, diesel-, and tobacco-tax collections processed in the 2007/08 fiscal year. Although the *Gasoline Tax* and *Fuel Tax* acts also mandate the taxation of propane, aviation fuel, and diesel used by railroads, we did not audit these areas because they account for only a small portion of total tax revenues and corresponding administrative activities.

Our audit followed the professional standards of the Canadian Institute for Chartered Accountants for assessing value for money and compliance. We set an objective for what we wanted to achieve in the audit and developed audit criteria that covered the key systems, policies, and procedures that should be in place and operating effectively. We discussed these criteria with senior management at the Ministry, who agreed to them. Finally, we designed and conducted tests and procedures to address our audit objective and criteria.

We also reviewed the Ministry's Internal Audit Service's more recent audit reports and the supporting working papers for the processing of tax receipts by the Client Accounts and Services branch, and the Revenue Collection branch's write-off of

accounts receivable as well as its review of the tax-roll registration process, and the posting of security requirements. Given the relevance and timeliness of their work, we were able to exclude these areas from our audit.

Summary

It is our view that the tax gap, which is the difference between the amount of tax that should be collected and the amount that is collected, has increased significantly with respect to tobacco tax since our 2001 audit of tobacco-tax collection. In fact, we believe that the tax gap with respect to tobacco could well be in the \$500 million range in 2006/07, on the basis of tobacco tax-rate increases and estimated consumption.

In response to our 2001 audit, the Ministry of Finance, which was then responsible for these commodity taxes, acknowledged that changes were needed to its policies and procedures, especially its supporting information technology systems, if it was to achieve full accountability for all gasoline, diesel fuel, and tobacco products at all stages of production and distribution and thus minimize tax leakage. However, many of these required changes have not been implemented. As well, the substantial increases to the tobacco tax rate and the major price increases for gasoline and diesel since our last audit have actually increased the incentive to evade taxes. As a result, it remains our view that the Ministry's current policies, procedures, and information technology systems are still inadequate to ensure that the correct amount of tobacco, gasoline, and diesel taxes is being declared and paid in accordance with the requirements of the law.

To address these risks, the Ministry needs to:

- identify and pursue policy options designed to mitigate incentives for the smuggling and sale of illegal tobacco products in order to reduce a possible \$500-million-a-year tax gap in 2006/07—options to be considered

should include changes to the *Tobacco Tax Act* to increase sanctions for non-compliance, and more targeted enforcement;

- work more closely with the Canadian Border Services Agency, the RCMP, and the OPP to more effectively reduce or eliminate the importation of illegal cigarettes into Ontario;
- more effectively ensure that purchases of tax-free cigarettes on First Nations reserves do not exceed the tobacco allocation assigned to each reserve;
- develop better policies and procedures to account for tobacco, gasoline, and diesel products at the various stages of the production and distribution process; and
- ensure that all required tobacco, gasoline, and diesel tax returns are properly completed, and thoroughly assess a sample of returns for completeness and accuracy.

It also continues to be our view that the Ministry needs to significantly strengthen its commodity-tax audit function and focus its inspection activities better to help ensure that undeclared taxes are identified and assessed.

Given the current staff resource levels assigned to most aspects of commodity-tax collection and the complexity of the gasoline and diesel returns in particular, significant improvements to the underlying information-technology systems are essential. Although we made a similar observation in our *2001 Annual Report*, the necessary technology improvements have still not been implemented.

OVERALL MINISTRY RESPONSE

Since the last audit of gasoline, fuel, and tobacco tax conducted in 2001, the Ministry has introduced a number of legislative amendments for registration and reporting, and increased fines and sanctions for non-compliance. The Ministry has increased the resources assigned to investigation and inspection, and continues to work with other jurisdictions to determine best practices related to commodity-tax administra-

tion. The Ministry is also in the process of implementing revised systems and administrative practices suggested by the Auditor General.

The size of the tobacco-tax gap cannot be known with any degree of certainty. There are many estimates, and they, of course, are determined by the sources of information used and the assumptions made in the calculation. What is key is that the problem is complex, is increasing, and requires the attention of Ontario and its intra- and inter-jurisdictional partners.

We would like to thank the Auditor General for the current recommendations, which will further assist the Ministry in making improvements to its administration of gasoline, fuel, and tobacco tax programs.

Detailed Audit Observations

OVERVIEW OF PROGRAM

The Ministry's Motor Fuels and Tobacco Tax Branch had overall responsibility for the administration and collection of tobacco, gasoline, and diesel-fuel taxes up to the end of the 2004/05 fiscal year. A ministry restructuring the following year eliminated the Motor Fuels and Tobacco Tax Branch and all other tax statute branches. Responsibility for the administration and collection of all provincial taxes is now the responsibility of the following eight functional branches:

- *Client Accounts and Services*: establishes and maintains tax rolls, processes tax returns, reviews and approves requests for refunds, and provides other client services;
- *Tax Compliance*: performs audits and inspections;
- *Tax Appeals*: administers the objection and appeals process;
- *Tax Advisory Services*: provides interpretations and advanced rulings, and assists in

the development of legislation and ministry policies and procedures;

- *Strategic Management Services*: provides planning, research, and change-management support, and serves as the lead on management of information-technology initiatives;
- *Special Investigations*: obtains intelligence on the underground economy, performs investigations, and maintains contact with other enforcement agencies, such as the OPP;
- *Revenue Collection*: deals with non-compliant and delinquent taxpayers, and recommends timely write-off of uncollectible amounts; and
- *Relationship Management and Business Development*: serves as the Ministry's primary point of contact for dealing with other governments and organizations.

As noted earlier, more than 95% of tobacco, gasoline, and diesel taxes are collected by a relatively small number of manufacturers and wholesalers called designated collectors.

TOBACCO TAXES

At the conclusion of our audit in early 2008, cigarettes and cut tobacco were taxed at 12.35 cents per cigarette or per gram of cut tobacco, while cigars were taxed at 56.6% of a predetermined taxable cost.

The tax rate on cigarettes and cut tobacco, in particular, have increased dramatically since 1999, as detailed in Figure 2.

These rate increases were intended to provide additional tax revenue and meet certain other public-policy objectives, including a reduction in smoking rates. However, they also provided a powerful incentive for the manufacturing and smuggling into Ontario of contraband and counterfeit tobacco products. As a result, it is all the more important that the Ministry have sufficiently strong policies and procedures to ensure that, as much as possible, the correct tax on all tobacco consumption is declared and paid.

Figure 2: Tax Rate on Cigarettes and Cut Tobacco, 1999–2006 (cents/cigarette and cents/gram)

Source of data: Ministry of Revenue

Effective Date	Tobacco Tax Rate
November 6, 1999	2.65
April 6, 2001	3.65
August 1, 2001	3.65
November 2, 2001	4.45
June 18, 2002	8.60
November 25, 2003	9.85
May 19, 2004	11.10
January 19, 2005	11.725
February 1, 2006	12.35

TAX GAP

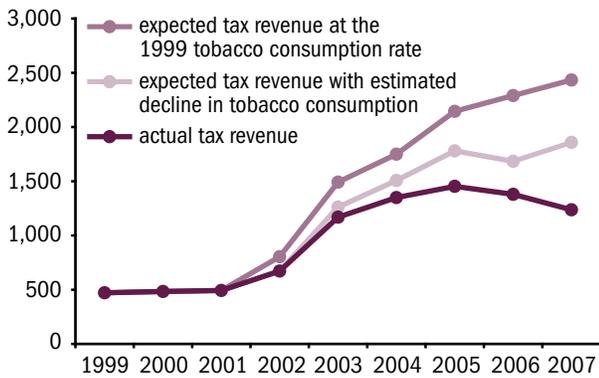
The increased incentive for tobacco smuggling notwithstanding, we found that the Ministry's systems and procedures for collecting tobacco taxes have not significantly changed or improved since the time of our last audit in 2001. We believe there is little question that the consumption of untaxed tobacco products and the resultant tax gap have both increased in recent years. For instance, if tobacco consumption since 1999 had remained constant, given a current tax rate that is about 4.7 times as high as in 1999, one would expect 2006/07 tobacco tax revenue to be \$2.2 billion rather than the \$1.2 billion actually collected. However, it is generally accepted that tobacco consumption has decreased in recent years. In its annual Canadian Tobacco Use Monitoring Surveys, Health Canada estimated that overall tobacco consumption in Ontario decreased by approximately 27% between 1999 and 2007. Even assuming a 27% decrease in consumption since 1999, the significant tax increases on tobacco during that same period should have produced a more than tripling of annual tobacco tax revenue, from about \$500 million in 1999 to as much as \$1.7 billion in 2007.

A comparison of *actual* annual tobacco tax revenue to *expected* tax revenue, based on both

constant consumption and a cumulative decrease in consumption totalling 27% for the years 1999 through to 2007, is detailed in Figure 3. Assuming a 27% consumption decrease since 2001, the potential tax gap for 2007 alone could be in the \$500 million range.

Figure 3: Actual vs. Expected Tobacco Revenue, 1999–2007 (\$ million)

Prepared by the Office of the Auditor General of Ontario



Inspection Program in March 2006 to conduct on-site inspections of tobacco stocks at retail outlets. Ministry inspectors currently target an average of 600 retail inspections each month. The targeted enforcement program is working. In the second year of operation, there has been a 50% reduction in the number of instances where contraband cigarettes are discovered.

With respect to the noted tobacco tax gap, the actual size of the gap cannot be known with any degree of certainty. If all illegal cigarettes were eliminated, it would be difficult to quantify the number of consumers who would simply not pay the current cost of legal cigarettes and would cease smoking. Therefore, the Ministry would not recover tax revenue equal to the estimated gap. The potential level of non-compliance is of concern to the Ministry, and the complexity of this issue will require a combination of policy, administrative, and enforcement activities.

RECOMMENDATION 1

In order to reduce the amount of tobacco tax revenue being forgone, the Ministry of Revenue should assess its policy options for mitigating the incentives for the smuggling and sale of illegal tobacco. Options could include increased sanctions for non-compliance with, and more targeted enforcement of, provisions of the *Tobacco Tax Act*.

MINISTRY RESPONSE

We agree with the recommendation. The Ministry will continue to work with its partner ministries and with other jurisdictions to mitigate the incentives for the smuggling and sale of illegal tobacco.

The Ministry has implemented a number of new enforcement provisions of the *Tobacco Tax Act*. For example, to ensure that tobacco products sold at the retail level in Ontario are tax-paid, the Ministry initiated the Tobacco Retailer

BORDER SECURITY AND CONTROL OF THE ILLEGAL TOBACCO TRADE

Border security and control of the illegal tobacco trade is primarily a joint responsibility of the Canadian Border Services Agency (CBSA), the RCMP, and the OPP, in conjunction with the Ministry's Special Investigations Branch. In interviews with representatives of all four organizations, it was clear they generally understood the magnitude and source of the illegal tobacco trade. However, all acknowledged limitations, including lack of resources and other supports to deal effectively with the issue. With respect to the OPP, for example, these limitations included:

- insufficient manpower and equipment;
- the fact that convictions under the *Tobacco Tax Act* do not result in a criminal record, leaving convicted individuals free to cross the border again;

- jurisdictional issues between the various police services, including pursuit policies that limit apprehensions; and
- the inability to enforce court-imposed fines.

Recent reductions in tobacco-tax revenues and our estimates of total tobacco consumption suggest the extent of tobacco smuggling into Ontario could be in the order of approximately 20 million cartons in 2007 alone (there are generally 200 cigarettes in a carton). However, we were advised that the RCMP, OPP, CBSA, and the Ministry's Special Investigations Branch seized a combined total of fewer than 1 million cartons in 2007—less than 5% of this potential illegal trade.

There is also ample anecdotal evidence that the illegal tobacco trade is significant. For example:

- The Canadian Convenience Store Association commissioned a study that collected cigarette butts outside 55 Ontario high schools between September 18 and October 5, 2007. It found that 31% of the butts were either illegal or of unknown origin.
- Health Canada's Canadian Tobacco Use Monitoring Survey noted that 21% of smokers reported buying tax-free cigarettes produced by First Nations manufacturers.
- There are numerous well-known sources of illegal cigarettes, including Internet websites and tobacco shacks adjacent to or located on First Nations reserves.

We also note that the trade in illegal tobacco contravenes legislation prohibiting sales to minors and bypasses such tobacco-control measures as the requirement for health warnings on packaging and disclosure of toxic ingredients.

RECOMMENDATION 2

The Ministry of Revenue should consult and work closely with the Canadian Border Services Agency, the RCMP, and the OPP to bring to bear the resources and policy changes necessary to deal more effectively with the importation of

illegal cigarettes and other tobacco products into Ontario.

MINISTRY RESPONSE

We agree with the recommendation. The Ministry will continue to foster partnerships with the agencies noted while at the same time recognizing that each brings a multi-focused mandate to the partnership equation. All of the enforcement agencies above recognize that there are synergies in working together and eliminating overlap where possible.

The Special Investigations Branch's recently created Intelligence Assessment Unit will allow for a more proactive approach, greater co-ordination of joint projects with existing partners, and better outreach capability to foster new partnership efforts.

TOBACCO ALLOCATION SYSTEM ON FIRST NATIONS RESERVES

The federal *Indian Act*, which supersedes provincial tax legislation, stipulates that persons defined as Indians under the Act are not subject to taxation in certain cases. As a result, Ontario allows First Nations people to buy tax-free tobacco products on reserves for their personal use.

Regulations under Ontario's *Tobacco Tax Act* limit the total number of tax-free cigarettes a reserve may purchase to 2.5 cartons a month for each of the total estimated adult reserve members who smoke and who live on the reserve, and 2.7 cartons a month for each of the total adult reserve members who smoke and live off the reserve. Estimates of the proportion of adults on each reserve who smoke are based on Statistics Canada data regarding the smoking patterns of First Nations people in Ontario. The regulation also allows reserves to purchase an additional 10% of their allocation for special occasions, and another 20% of their allocation when a band council enters into

an agreement to assign the allocation among the band's retailers and to monitor their tobacco sales.

Our review of tobacco-tax returns submitted by the three major cigarette manufacturers and other designated collectors found that all reported that they adhered to the tobacco allocation system and limited their tax-free cigarette sales to First Nations reserves to the maximum allowed under the regulation.

However, we also understand that there are a number of manufacturers/wholesalers that have operations on reserves that sell cigarettes to reserves over and above the bands' existing allocations. For instance, one of these manufacturers/wholesalers sold, to 16 reserves, an average of 27 cartons a month for every adult band member who smokes, and to another reserve over 400 cartons per month—a quantity that is well beyond what could reasonably be assumed necessary for personal use and that almost certainly includes cigarettes destined for sale to non-band members.

We also noted the following:

- One manufacturer/wholesaler alone sold more than 250% of the total allocation for all adult band members who smoke and live in Ontario for the 2006/07 fiscal year, at a cost to the Ministry in forgone tax revenue of more than \$100 million for that year alone.
- The same manufacturer/wholesaler sold tax-free cigarettes to 28 retailers not registered with the Ministry and therefore not authorized to purchase and resell tax-free cigarettes.

RECOMMENDATION 3

To help meet the intent of the Tobacco Allocation System for First Nations reserves, and to prevent the diversion of untaxed cigarettes to off-reserve sale and consumption, the Ministry of Revenue should ensure that a reserve's purchases from all sources, including on-reserve manufacturers and wholesalers, is limited to the tobacco allocation assigned to that reserve. The Ministry should also consider other options

such as greater incentives to First Nations band councils to reduce or eliminate the on-reserve production or purchase of cigarettes for off-reserve consumption.

MINISTRY RESPONSE

We agree with the recommendation and will continue to work within the government framework for discussions with First Nations.

First Nations reserves are primarily federal areas of responsibility. So while an on-reserve tobacco business may be subject to certain provincial tobacco tax requirements, such as the requirement to obtain a tobacco wholesaler or vendor permit and collect tobacco taxes from non-Indians, there are limitations on the province's ability to enforce provincial tobacco tax laws on reserves.

To facilitate greater co-ordination and effectiveness among levels of government, Ontario recently amended the *Tobacco Tax Act* to permit the exchange of information with other governments and municipalities and their agencies, boards, and commissions, where the information is used in the enforcement of legislation relating to or regulating the manufacture, distribution, export, import, storage, sale, or advertisement for sale of tobacco.

The Ontario government expressed its intention in the 2007 Throne Speech and 2008 Ontario Budget to work with Aboriginal peoples in Ontario to expand economic development opportunities and improve their quality of life.

CIGAR TAXES

Although our *2001 Annual Report* recommended that the Ministry consider an allocation system for cigars similar to that in place for cigarettes, we note that no such system had been implemented at the time of our audit. As a result, Ontario is one of just three jurisdictions in Canada—Nunavut and

the Yukon are the others—that do not limit sales of untaxed cigars on First Nations reserves.

As was the case at the time of our audit in 2001, it is our view as well as the Ministry's that the tax forgone on cigar sales to and from reserves is significant. For example, the Ministry determined the following for the 2006/07 fiscal year:

- Approximately 76 million cigars were sold tax-exempt to First Nations reserves by off-reserve manufacturers over and above the Ministry's estimated reserve consumption.
- The estimated tax forgone on these 76 million cigars is approximately \$26.6 million.
- Almost all of the tax-exempt cigars were sold to just two reserves.

RECOMMENDATION 4

To help ensure that the number of tax-exempt cigars sold to First Nations reserves is reasonable and is not diverted to untaxed off-reserve sale and consumption, the Ministry of Revenue should develop and implement an allocation system for cigars similar to that for cigarettes, as is done in most other Canadian provinces, and ensure that it is adhered to.

MINISTRY RESPONSE

We agree with the recommendation. The Ministry is reviewing options for an allocation system for cigars and continues to consult with interested parties regarding ongoing and emerging issues that affect the feasibility of implementing a cigar allocation system. Regulatory change would be a necessary next step to effect the extension of the allocation system to include cigars.

CIGARETTE PRODUCTION AND CONTROL

There are three large recognized manufacturers of Canadian-branded cigarettes that either manufacture cigarettes in Ontario or import them into

the province. Cigarettes manufactured for taxable consumption in Ontario are marked with a yellow tear-tape in the wrap of each package. Cigarettes manufactured for consumption in other jurisdictions or for tax-exempt use on First Nations reserves are marked with a tear-tape in a colour other than yellow.

There are at least three ways to hold cigarette manufacturers accountable for the number of cigarettes they produce and sell, and help ensure that the correct amount of tax is declared and paid. These include:

- placing ministry representatives in production facilities to observe and account for all cigarettes produced;
- requiring manufacturers to account in a verifiable way for the quantity of raw tobacco leaf purchased to determine the quantity of cigarettes produced; or
- requiring cigarette manufacturers to mark tax-paid cigarettes by, for example, the use of yellow tear-tape in packaging, as they have been doing since our last audit in 2001, and then require makers of cigarettes and tear-tape to account for the quantity of yellow tear-tape material purchased and used, and reconcile it with the amount of tax remitted to the Ministry.

As a result of our recommendation in this area in 2001, the Ministry has since January 2006 received information monthly about tear-tape purchases and consumption by individual cigarette manufacturers, as well as sales by tear-tape manufacturers to cigarette makers. However, this data is of little value because:

- The information received from both the tear-tape manufacturers and cigarette makers does not distinguish between yellow and the various other tear-tape colours used either for tax-exempt consumption on reserves or for taxable sale outside Ontario.
- The Ministry has not yet attempted to estimate whether the amount of tear-tape used is

reasonable in comparison to taxes remitted on taxable yellow tear-tape products sold.

Our review of tear-tape purchases by cigarette makers and tear-tape sales reported by manufacturers found a number of discrepancies. In one month alone, for example, one tear-tape manufacturer reported 14 million metres of tear-tape sales more than the corresponding purchases reported by the cigarette maker. If this tear-tape was all yellow and subsequently used on taxable products but not reported as such, we estimated this could have a potential lost-tax value of approximately \$173 million.

RECOMMENDATION 5

The Ministry of Revenue should assess its various options for ensuring that all cigarettes manufactured and packaged for taxable consumption in Ontario are accounted for and the applicable tax paid. If it decides to continue the use of yellow tear-tape to mark cigarette packages for taxable consumption in Ontario, it should:

- receive sufficiently detailed information about yellow tear-tape material sold to, and acquired and used by, cigarette manufacturers; and
- reconcile the information received to assess the reasonableness of the reported use of yellow tear-tape material in relation to reported taxable sales.

MINISTRY RESPONSE

We agree with the recommendation. The Act and regulations were amended to establish a system for monitoring the manufacture, distribution, inventory, sale, and use of tear-tape for Ontario. Fines and penalties for failure to comply with these provisions have been enacted.

Since the last audit, the Ministry has registered the three tear-tape manufacturers and is now receiving production and sales information about yellow tear material from them.

The Ministry will examine the ability to reconcile this information with the number of packages of cigarettes manufactured and on which tear-tape has been affixed. The challenges of such an exercise include tear-tape waste in the process (for example, tear-tape gets tangled in the machine) and cigarette manufacturers changing the size and shape of the cigarette packages, affecting the amount of tear-tape used on each pack.

As suggested in the recommendation, the Ministry will determine whether the provision of tear-tape information by tear-tape manufacturers can assist us in validating the information provided to us by manufacturers with respect to sales of taxable and exempt cigarettes.

TOBACCO TAX-RETURN PROCESSING

Designated collectors, importers, exporters, and transporters of tobacco products are required to file monthly returns in a prescribed format. These returns must include:

- information about production, imports, and exports of the applicable commodity;
- listings that detail tax-exempt sales to, and purchases from, other designated collectors; and
- listings that detail the total amount of taxable sales.

The information in these returns is intended to provide the Ministry with sufficiently detailed and corroborating information from third parties to assess the completeness and accuracy of taxable sales reported by the designated collectors.

However, our review of the tax-return processing function and samples of processed tax returns noted the following:

- The Ministry had at the time of our audit either not received, or could not find, a number of the returns we requested for review.

- Many of the returns we reviewed were incomplete and lacked, for example, some of the required detailed schedules.
- There was no evidence in the returns we reviewed that the Ministry had attempted to verify the completeness and accuracy of the information in those returns. Instead, it appeared that individuals processing the returns had ensured only that the amount of tax declared as payable on the return was equal to the payment received.

Our review of a small sample of returns noted many instances where, for example, one collector's reported tax-exempt purchases did not agree with the seller's reported tax-exempt sales to that collector. Although the individual discrepancies were generally small, the total across all returns could be significant.

We also noted that tax returns are reviewed and processed manually. It is our view that in light of the volume of transactions involved, the Ministry should reassess whether it has adequate staff resources to conduct this process effectively.

RECOMMENDATION 6

To help ensure that all cigarette and cigar production and imports are accounted for, and to help assess the reasonableness of reported taxable sales, the Ministry of Revenue should ensure that it:

- receives and retains all required tax returns, and that the returns are complete and include all the required detailed schedules;
- thoroughly assesses on a sample basis the completeness and accuracy of the reported information; and
- diligently follows up on significant, unusual, or otherwise questionable items.

MINISTRY RESPONSE

We agree with the recommendation. The Ministry created three new schedules in 2005 to

assess the reasonableness of reported taxable sales. However, the industry changed dramatically over a short period of time (from 2005 to the present). As a result, the schedules could not be completed by out-of-province collectors who do not manufacture in Ontario. The Ministry made interim administrative concessions because these collectors simply could not provide the data or required an inordinate amount of administrative work to complete these new schedules.

The Ministry is currently undertaking a review to identify the data required to assess effectively the completeness and accuracy of taxable tobacco sales in Ontario.

GASOLINE AND DIESEL TAXES

Although the tax rates on gasoline and diesel fuel used for transportation purposes have not increased since our last audit in 2001, total revenues have risen about 15% over those seven years. Current tax rates, along with revenues in the 2000/01 and 2007/08 fiscal years, are illustrated in Figure 4.

Diesel is not taxed when used for heating, in most off-road vehicles, or for machinery used in manufacturing, farming, or construction. Tax-exempt diesel is dyed at the refinery or at bulkstorage facilities while

Figure 4: Tax Revenue by Fuel 2000/01–2007/08

Source of data: Ministry of Revenue

Product	Tax (cents/ litre)	2007/08	2000/01
		Fiscal Year Revenue (\$ million)	Fiscal Year Revenue (\$ million)
gasoline—leaded	17.7	2,368	2,045
gasoline—unleaded	14.7		
diesel—non-railroads	14.3	707	613
diesel—railroads	4.5	29	30
propane fuel	4.3	3	10
aviation fuel	2.7	67	56

taxable diesel fuel is left clear to help distinguish between the two.

The Ministry's systems and procedures for the collection of gasoline and diesel taxes have remained unchanged since the time of our last audit in 2001 and are as follows:

- The Ministry designates as collectors all those refiners and wholesalers who in the previous year sold not less than 51% of their product by volume at wholesale. Tax is imposed whenever a designated collector sells a taxable product to a non-collector, or when a registered importer who is not a collector imports taxable products. Sales between collectors and sales for export are tax-exempt. Collectors, and registered importers who are not collectors, must file monthly tax returns and include payment of the correct amount of tax.
- Exporters and all transporters of petroleum products must be registered with the Ministry. Although they are not required to remit taxes, they must file monthly returns detailing their movement of petroleum products. This information is intended to help the Ministry determine whether all products available for taxable consumption are accounted for.
- Importers not registered with the Ministry are required to remit the correct provincial tax to the Canada Border Services Agency at the time they import a taxable product, and the Agency then forwards the tax to the Ministry.

GASOLINE AND DIESEL PRODUCTION AND CONTROL

Four companies operating five refineries account for virtually all petroleum products produced in Ontario. At the time of our audit in 2001, we noted that the Ministry did not require these refiners to report the amount of gasoline and diesel they actually produced. As a result, the Ministry could not at that time assess whether all gasoline and diesel produced was reported as sold or otherwise accounted

for; nor could it determine whether the correct amount of tax had been declared and paid.

We are pleased to report that as a result of a recommendation in our *2001 Annual Report*, the Ministry now receives monthly information from each of the refiners about the amount of gasoline and diesel they produce. However, as noted in the following section, there is no evidence that the Ministry is assessing the completeness and accuracy of the reported information, either at the time it processes the returns or during any subsequent audits. As a result, we continue to be concerned that the Ministry is not assessing whether all the gasoline and diesel produced is reported as sold or otherwise accounted for, and that the correct amount of tax is ultimately declared and received.

GASOLINE AND DIESEL TAX-RETURN PROCESSING

As with the tobacco tax, designated collectors and transporters of gasoline and diesel tax are required to file a monthly return. These returns must include detailed schedules with respect to tax-exempt sales to, and purchases from, other designated collectors, along with imports and exports, and the total amount of taxable sales.

Although the Ministry had developed a detailed checklist for processing these returns since our last audit, this checklist was not being used. We were advised that, instead, the tax-return-processing function consisted essentially of a high-level review of the return to ensure that, for example, required schedules are attached and agree in total with the tax return, and that the amount of tax declared is actually received. However, where required schedules were missing or lacked necessary information, there was in most cases no evidence of any follow-up by the Ministry; nor was there any evidence of supervisory review.

We were advised that the Motor Fuels and Tobacco Tax Branch had implemented a desk-audit function to analyze and perform detailed verification of the information reported in the

returns. However, that function was discontinued subsequent to the Ministry reorganization during the 2005/06 fiscal year and there is currently no process in place to assess the completeness and accuracy of information reported in the returns. For example, the Ministry has no way of reconciling reported tax-exempt purchases and sales between designated collectors, or of verifying imports and exports reported by collectors against the independent information submitted by inter-jurisdictional transporters.

Our detailed review of one month's tax return for seven different collectors noted the following:

- Designated collectors reported selling 128 million more litres of tax-exempt fuel to other collectors than those collectors reported purchasing. If this fuel was sold, for instance, at the retail level and the appropriate tax paid by consumers but never remitted, the potential tax loss could be as high as \$19 million.
- Reported imports and tax-exempt exports by the collectors could not be corroborated with transporter returns showing the product was shipped outside of Ontario because the transporters were not identified in the collector tax returns. Furthermore, customs documentation, bills of lading, and invoices for the exported product are often not received even though they are required to be submitted.

We did note that since the time of our last audit, the Ministry had developed a computerized information system to allow electronic matching of data entered manually from the various return schedules. However, the system had not been tested and implemented, with the result that returns processing and verification continued to be done manually. In our view, this is impractical, given the number of transactions and the resources assigned to this function.

RECOMMENDATION 7

To help ensure that all gasoline and diesel production can be accounted for, and to help assess

the reasonableness of reported taxable sales, the Ministry of Revenue should ensure that:

- all returns received are completed and include, for example, all required detailed schedules and documentation;
- it thoroughly assesses on a sample basis the completeness and accuracy of the reported information;
- it diligently follows up on significant, unusual, or otherwise questionable items; and
- it expedites its planned implementation of a computerized tax-return-processing function.

MINISTRY RESPONSE

The Ministry agrees with the recommendation. Similar to our response to Recommendation 6, the Ministry is currently undertaking a review to identify the data required to effectively assess the completeness and accuracy of taxable gasoline and diesel sales in Ontario. In addition, the Ministry has taken steps to reinforce administrative practices and controls related to the storage and retention of tax returns.

We will continue to look for opportunities to improve reconciliation processes when we transition the administration of gasoline and fuel tax into the Ministry's integrated tax system known as ONT-TAXS.

GASOLINE TAX EXEMPTIONS

Under the *Gasoline Tax Act*, First Nations people who hold a valid Certificate of Exemption issued by the province of Ontario are entitled to purchase tax-exempt gasoline on a reserve for their personal use.

For each tax-exempt sale, the retailer must complete a pre-numbered Ministry-issued voucher indicating:

- date of sale;

- purchaser's name and vehicle licence plate number;
- total sales proceeds (including tax);
- number of litres purchased;
- the provincial tax per litre;
- the tax included in the total sale; and
- the net cost to the First Nations person with the exemption card.

The voucher must also be signed by the purchaser and include an imprint of the Certificate of Exemption.

In most cases, the retailer pays the gasoline tax on purchasing the gasoline inventory, and then submits a request for a tax refund directly to the Ministry. First Nations gasoline refunds for the 2007/08 fiscal year totalled approximately \$21.3 million.

Refund claims are to be reviewed by the Ministry for completeness and accuracy, as well as for high volume or otherwise unusual purchases. When necessary, the Ministry must contact the retailer or purchaser to obtain additional information needed to verify the tax-exempt status of the purchases. Information provided by the Ministry indicated that for 2006 and 2007, 55 refund claims were adjusted or disallowed, although the total value of the amounts adjusted or disallowed is not known.

Our review of a sample of refund claims paid by the Ministry found many questionable items similar to those noted in our *2001 Annual Report*. For example:

- In many cases, refund vouchers lacked the required imprint of the Certificate of Exemption or the vehicle licence plate number.
- Retailers frequently submitted consecutively numbered vouchers for the purchase of identical quantities of gasoline, which should have been followed up on or disallowed. For example, one retailer submitted 16 consecutively numbered refund vouchers for 53 litres each, and another submitted 15 consecutively numbered refund vouchers for 47.11 litres each.

We also note that the Certificates of Exemption issued by the province never expire, and controls

over the issuing of these certificates have been lax. For example:

- The Ministry did not maintain any information with respect to the number of Certificates of Exemptions issued, or to whom they were issued, prior to 2000.
- Although the Ministry has maintained information with respect to the number of Certificates of Exemptions issued, and to whom, since 2000, there are no procedures in place to prevent the issuing of a new certificate to someone who already had one prior to 2005, or to cancel any previously issued Certificates of Exemption.

RECOMMENDATION 8

To help ensure that gasoline tax refunds are only issued for eligible gasoline purchases, the Ministry of Revenue should:

- exercise more vigilance in its review of refund vouchers and, where information is questionable or missing, ensure that an appropriate follow-up with the retailer is done prior to allowing the claim; and
- strengthen its procedures for the issuance and cancellation of First Nations Certificates of Exemption.

MINISTRY RESPONSE

Effective September 2008, the Ministry has moved to electronic receipt of First Nations gasoline tax-refund claims to improve validation of refunds and First Nations Certificates of Exemption. We will continue to partner with Indian and Northern Affairs Canada (INAC) as it modernizes the Status Indian identification card with a view to enhancing and streamlining the provision of statutory refunds to First Nations individuals.

GASOLINE, DIESEL, AND TOBACCO TAX AUDITS

As the information reported in tax returns is not verified at the time of processing, and in the absence of a desk-audit function, field audits become all the more critical for detecting any undeclared or unpaid taxes. We noted that gasoline and diesel tax audit assessments averaged approximately \$5.4 million per year in the last four years, while tobacco tax audit assessments averaged \$1.7 million in the same period.

Audit Coverage

Although the Ministry's other taxation programs have established tax-revenue thresholds for registrants for the purpose of setting audit coverage goals, no similar thresholds have been established for the gasoline, diesel, and tobacco tax programs. Instead, we were advised that the Ministry's goal is to audit the largest and riskiest collectors on a four-year cycle in order to fall within the legislated allowable periods for reassessment. Thirty-eight of 104 tobacco tax collectors and seven of 89 gasoline and fuel collectors were assigned to this category.

Our review of the Ministry's audit coverage for these collectors noted that:

- Only a few of the 38 large tobacco tax collectors have been audited at least once every four years as planned. While some of the remaining collectors have been audited once in the last six years, many, including the three main manufacturers, have only been audited once in the last 10 to 15 years. Similarly, the majority of the remaining small collectors have not been audited in the past 10 years.
- All seven of the large gasoline and diesel tax collectors have been audited every four years as planned. However, the majority of the remaining 82 small collectors have not been audited in the last 10 years.

Audit Working-paper Files

Audits help determine if the correct amount of tax has been declared and paid. For this reason, it is necessary to document audit working papers properly to demonstrate that audits have been properly planned and satisfactorily completed. We consequently requested a sample of audit working-paper files for our review.

Although we found in the files we reviewed that the assessments issued were adequately supported, we identified a number of concerns, including the following:

- Several of the working-paper files we requested could not be located and thus could not be reviewed.
- There was generally no evidence of audit planning to ensure that areas with a high risk of non-compliance were identified and the necessary audit procedures performed. In light of the very limited audit resources the Ministry has allocated to gasoline, diesel, and tobacco tax audits, adequate audit planning to ensure the audit focuses on the areas of highest risk is particularly important.
- Although the Ministry had developed a detailed audit program as a result of a recommendation in our 2001 report, we found this program was either not in the files we examined or, when it was, had not been signed off and cross-referenced to indicate which audit steps had been performed.
- In general, most working-paper files were difficult to follow and consisted primarily of photocopies with no indication of what, if any, audit work had been performed.
- With one exception, all working-paper files lacked evidence of managerial review and approval, either at the planning stage or at the conclusion of fieldwork.

We also noted several instances where auditors were told by their managers to terminate an audit and issue a nil assessment—indicating that no tax was owed—without documenting in the file the reasons for doing so.

RECOMMENDATION 9

To help ensure that audit work is satisfactorily planned and completed, and clearly determines and demonstrates whether the correct amount of tobacco, gasoline, and diesel tax has been declared and paid, the Ministry of Revenue should:

- complete audits of the largest and higher-risk designated collectors within the planned four-year periods to ensure that the audits do not fall outside the legal time limits for reassessment;
- ensure that all working-paper files are retained and clearly document the work done and decisions made; and
- require supervisory review and approval and documentation of decisions made, both at the planning stage of an audit and at the conclusion of fieldwork, to help ensure that work is focused on the areas of highest risk of non-compliance and that the work necessary to mitigate the identified risk is adequately completed.

MINISTRY RESPONSE

The Ministry agrees with the recommendation and is in the process of implementing it. For example, all large remitters that have not been audited in the last four years have been identified and will be prioritized for audit in the current and next fiscal years.

The Ministry's Tax Compliance Branch, as part of its recent restructuring, has created a training unit to support the delivery of the program and the ongoing training of both auditors and their managers. Work is currently being done on developing a file-documentation training package that will be presented to audit staff.

Managers will be more diligent in their involvement in the audit process, from audit selection to file documentation to auditing areas of risk.

Further improvements in the area of managing the audit process will come with the implementation of corporate initiatives such as risk-based audit selection and ONT-TAXS.

FIELD INSPECTIONS

Gasoline and Diesel Inspections

The primary objective of the gasoline and diesel inspection unit is to deter the illegal use of tax-exempt dyed diesel in vehicles driven on provincial roads and highways. Field inspectors primarily conduct random roadside inspections of diesel-powered vehicles to ensure that they are using only clear, uncoloured fuel on which tax has been paid. Traditionally, they also inspected fuel terminals, bulk-storage facilities, and retail outlets in search of dyed untaxed fuel. However, the risk that these facilities have quantities of inappropriately stored untaxed fuel has been assessed as low, and so the number of these inspections has been significantly reduced.

Where the illegal use of untaxed fuel is detected, inspectors will issue a Provincial Offences summons, similar to a parking ticket. They may also issue a tax assessment based on an estimate of the tax payable for all fuel used in the vehicle since it was new, unless the owner can prove that tax was paid on fuel previously used in the vehicle.

We noted that for the 2006/07 fiscal year, the Ministry's seven gasoline and diesel inspectors issued just 24 assessments, with a total value of \$42,000. In the 2007/08 fiscal year, the same seven inspectors issued 38 assessments worth \$152,640. This compares to the similarly modest results at the time of our last audit in 2001, when 12 inspectors issued assessments totalling \$260,000 in the 2000/01 fiscal year.

There is no evidence that the Ministry has assessed the likely extent and risks associated with various tax-evasion schemes. Based on this and the fact that each inspector issues an assessment on

average only once every three or four months, we question whether its current inspectors are being effectively deployed.

RECOMMENDATION 10

To maximize the benefits of its diesel-fuel inspection program, the Ministry of Revenue should:

- formally assess the likely risk and extent of the use of untaxed fuel in vehicles operating on provincial roads and highways;
- develop an inspection strategy that is tailored to the risks identified and that has the best chance of deterring or identifying the illegal use of untaxed fuel; and
- assess the results of improving its enforcement efforts before concluding that more inspectors are needed.

MINISTRY RESPONSE

The Ministry frequently reviews its approach to managing the coloured-diesel-fuel inspection program. For example, this fiscal year, the frequency of inspection of terminals and bulk plants has been reduced in recognition of the level of tax compliance. Emphasis has shifted instead to coloured-fuel checks of vehicles, large consumers of diesel fuel, and wholesalers because the risk factors in these areas have increased with the rise in the price of fuel. The first line of detection of abuse in this area is the sampling of fuel in the running tanks of licensed vehicles of large consumers of diesel fuel.

Tobacco Retail Inspection Program

The Ministry initiated the Tobacco Retail Inspection Program (Program) in early 2006 and assigned 33 inspectors to it during the 2007/08 fiscal year. We understand that the Ministry intends to increase the number of inspectors shortly to 58.

Under the Program, inspectors visit convenience stores and other retail outlets to search for tobacco

products, such as illegal unmarked cigarettes and quantities of legally marked cigarettes, that cannot be substantiated with supplier invoices. Where they find such inventories, inspectors seize them and issue an assessment equivalent to three to eight times the tax that should have been paid on both the illegal and the legal but unsubstantiated inventories.

Ministry records indicate that in the 2007/08 fiscal year, the 33 inspectors conducted about 5,500 store visits, seized approximately 3,500 cartons of cigarettes, and issued assessments worth a total of about \$3.1 million. We also understand that most of the amounts assessed have not been collected, and may never be if the store goes out of business. In addition, we noted that the value of assessments in 2007/08 declined by about 40% from the previous year, even though the quantity of cigarettes seized actually increased.

At first glance, this would appear to be a successful enforcement initiative, and the Ministry plans to increase the total number of convenience store inspectors by 75% to 58. However, the quantity of cigarettes seized and the amount of taxes assessed as a result of inspections account for an extremely small percentage of what we estimate to be a \$500-million-a-year tax gap. We question whether a better return might result from increased enforcement in other areas.

RECOMMENDATION 11

The Ministry of Revenue should assess whether the planned expansion of the Tobacco Retail Inspection Program is the most effective way to detect and deter sales of untaxed cigarettes, or whether a more concentrated effort at the point of manufacture or importation of untaxed cigarettes into Ontario would yield a better return.

MINISTRY RESPONSE

The Tobacco Retailer Inspection Program has proven to be very effective in limiting the quantity of untaxed/illegal cigarettes available to consumers at the retail level.

In the last two years, the Program assessed penalties of \$7.9 million and confiscated approximately 828,000 cigarettes. With the increased staff, the program will visit each retail site approximately once per year. The physical presence of ministry staff in communities across the province, coupled with the inspection of retail stores in these communities, is proving to be an effective tool in addressing the contraband issue at the retail level, which is the largest network of sites (approximately 15,000 to 25,000 stores in Ontario) where consumers can purchase cigarettes.

The Ministry agrees that the Tobacco Retailer Inspection Program alone will not address the contraband problem. The involvement of other enforcement agencies and the federal government is necessary to deal with this issue.

BUSINESS PROCESS RE-ENGINEERING

As previously noted, returns and supporting schedules for gasoline, diesel, and tobacco taxes are filed monthly in paper form. It is our view that this system is impractical, given the number and variety of such transactions.

At the time of our audit in 2001, the Ministry said it had initiated a comprehensive business re-engineering project in 1997. Initially, the project

was to have been completed in 2001, but that was later revised to 2003. The project was to have included such features as:

- electronic filing of tax returns, including all required supporting information;
- electronic processing of returns; and
- extensive data comparison and analysis capability to help verify the accuracy and completeness of information in the returns and supporting documents.

However, we now understand that this business re-engineering project will not be completed and will be replaced by a new ONT-TAXS accounting system for commodity tax programs in the 2009/2010 fiscal year. The underlying design and functionality of this new system is still in the planning stages. Therefore, it has not yet been determined whether the features that were to be included in the former business re-engineering project will be included in the new system.

We believe that a well-designed system that incorporates the above features would facilitate the identification of potential transactions for which tax was not paid that warrant further investigation. Given the billions of tax dollars involved, we encourage the Ministry to invest the necessary resources in system planning and up-front design to ensure the appropriate functionality. As well, appropriate research on other jurisdictions' "best of breed" commodity tax systems should be conducted.