MINISTRY OF FINANCE

4.02–Corporations Tax

(Follow-up to VFM Section 3.02, *2002 Annual Report*)

BACKGROUND

Generally, the *Ontario Corporations Tax Act* imposes taxes on all corporations that have a permanent establishment in Ontario or that owned and received income from or disposed of real property in Ontario. For the 2003/04 fiscal year, the province recorded approximately $7.3 billion in corporations taxes ($6.6 billion for the 2001/02 fiscal year). In 2001/02 the Corporations Tax Branch had about 770 staff (including staff at regional tax offices) and had expenditures of about $45 million, of which 90% was for salaries and benefits.

In 2002, we concluded that where corporations did not voluntarily comply with the provisions of the *Ontario Corporations Tax Act*, the Ministry did not have adequate policies and procedures in place to ensure that the appropriate amount of corporations tax was being declared and remitted by taxpayers in accordance with statutory requirements. We also noted that the tax gap with respect to provincial corporations tax—that is, the difference between the amount of corporations tax actually collected and the amount that should be collected—may well be substantial. In this regard, we found that the Ministry did not assess or evaluate the extent to which the overall tax gap affected provincial corporations tax revenue, or their collection efforts.

We noted an increase in the extent to which corporations did not voluntarily comply; of the 763,000 corporations with active accounts on the Ministry's tax roll, 355,000 corporations—or one in two—did not file required returns. In 1996, at the time of our last audit, about one in five corporations did not file required returns.

We also noted that the Ministry did not regularly compare all active registrants in the Ministry of Consumer and Business Services' (MCBS) database with those on the corporations tax roll to ensure that all corporations that are registered with MCBS and are required to file a tax return continue to be included in the corporations tax roll.

With respect to its function of auditing corporations tax returns, we found that for corporations with annual gross revenues of $500,000 and over, the number of desk audits completed was about half of the number planned. For the corporations that have gross revenues under $500,000, which represent about 87% of the total number of corporations on the tax roll, very few field or desk audits were performed. Although the Ministry had made a deliberate decision to rely on the Canada Customs and Revenue Agency (now officially named the Canada Revenue Agency) for the audit of smaller corporations, we noted that it had not obtained the necessary information to assess whether such reliance was justified.

We made a number of recommendations for improvement and received commitments from the Ministry that corrective action would be taken.

CURRENT STATUS OF RECOMMENDATIONS

According to information received from the Ministry of Finance, substantial progress has been made on many of the recommendations in our *2002 Annual Report*. The current status of action on each of our recommendations is as follows.

TAX RETURN FILING

Recommendation

To help ensure that all required corporation tax returns are received and processed and that the appropriate amount of taxes is collected, the Ministry should:

- *regularly compare the corporations registered in the Ministry of Consumer and Business Services database with those in its own corporations tax database and investigate and resolve discrepancies on a timely basis;*
- *make better use of available tools to enforce compliance by defaulting corporations; and*
- *assess whether additional resources and procedures are warranted to follow up on all outstanding returns and ensure that those returns are appropriately submitted.*

Current Status

A Memorandum of Understanding now exists between the Ministry of Finance and the Ministry of Consumer and Business Services (MCBS) that formally requires that data contained in the two respective ministries' databases be synchronized every six months. According to the Ministry of Finance, any discrepancies found in the synchronizations are investigated. In addition, the Ministry informed us that it now uses weekly electronic data updates from MCBS to update the corporations tax roll on an ongoing basis.

With respect to enforcing compliance and following up on outstanding returns, the Ministry informed us that in April 2003, it issued follow-up notices demanding filing of either outstanding tax returns or exempt-from-filing declarations to all 340,000 corporations that had not filed these. Second notices were issued in November 2003 to the 240,000 corporations that did not respond to the first notices. About 150,000 corporations did not respond to the second notice. At the time of our follow-up, corporations that had failed to respond to the second notice were being subjected to progressive enforcement action, which includes phone calls, arbitrary assessments, prosecution of directors under the *Provincial Offences Act*, and charter cancellation. In the 2003 Ontario Budget, resources were allocated to perform these activities, with an expected clearance of the backlog within the next five years.

Also, in February 2004, the Ministry commenced an ongoing follow-up program to help ensure that the filing of corporations tax returns is kept current.

TAX RETURN PROCESSING

Recommendation

To ensure that filed returns can be processed and that the correct amount of tax is collected or refunded on a timely basis, the Ministry should follow up on missing information or, when necessary, verify information provided in returns on a timely basis.

Current Status

The Ministry advised us that an automated process has been set up to deal with corporations that file the current year's return but are in default of filing a prior year's return (since being thus in default, along with submitting returns where information is missing, are the two circumstances under which filed returns cannot be processed). The Integrated Tax Administration System (ITAS) automatically produces stage-one default letters that request that the return be filed. An automatic notepad entry is created that produces an audit trail. Approximately two months after the stage-one letter is sent, any taxation periods still in default are identified by ITAS. A stage-two letter is issued that informs the corporation that, if the return(s) is(/are) not received within 30 days, the Minister may issue an arbitrary assessment. ITAS identifies the accounts that have not responded to the stage-one and stage-two letters, and the accounts are forwarded for potential arbitrary assessment.

The number of returns that could not be processed because of missing prior years' returns has been reduced from 19,448 in December 2002 to 2,988 in June 2004. The Ministry has also improved the timeliness of its follow-up process for missing information by sending letters, on a more timely basis, detailing what information is required for the Ministry to process the return. Where information is required from the corporation in order to process a tax return, the Ministry sends an information request within 60 days.

MINISTRY AUDIT ACTIVITIES REGARDING TAXPAYERS

Audit Coverage

Recommendation

In order to meet its objectives of ensuring that corporations selected for audit declare and remit the correct amount of tax as well as encouraging broad-based voluntary compliance with the Ontario Corporations Tax Act*, the Ministry should:*

- *conduct the planned number of discretionary desk audits of corporations with annual gross revenues of between $500,000 and $7 million; and*

- *consider the advisability of auditing, based on assessed risks, more corporations with annual gross revenues of under $500,000.*

Alternatively, if the Ministry continues to rely on Canada Customs and Revenue Agency (CCRA) audits, the Ministry should obtain and monitor specific information about the CCRA small-business audit program so that it can assess whether the program is meeting its expectations and whether the Ministry's reliance on the CCRA audits is justified.

Current Status

The Ministry informed us that it resumed discretionary desk audits on October 1, 2003 and exceeded its audit coverage target for the second half of the 2003/04 fiscal year. The Ministry acknowledged the importance of discretionary desk audits and indicated that it was committed to meet its future targets as planned.

The Ministry also informed us that it has determined that some reliance on the Canada Revenue Agency (CRA) (formerly Canada Customs and Revenue Agency) for small business audits is justified. In addition, at the time of our follow-up the Ministry was formulating its own small-business audit strategy to complement that of the CRA.

The Ministry also created a new field audit group in 2003 to perform audits of exempt-from-filing declarations, tax credits, and smaller corporations on an ongoing basis. Full staffing of this unit was completed by mid-2004.

Discretionary Field and Desk Audits—Audit Selection

Recommendation

To ensure that the Ministry's audit function meets the Ministry's compliance and tax collection objectives efficiently and effectively, the Ministry should ensure that:

- *its audit selection process assesses the risk of significant non-compliance for all corporations and selects those with the highest assessed risk of significant non-compliance; and*
- *it monitors the range of corporations selected for audit to ensure that it is sufficiently diverse in terms of industry type and location to encourage broad-based, voluntary compliance.*

Current Status

The Ministry informed us that a working group of audit managers was formed to consider various risk management tools to improve the audit selection process. The working group's report addressed the primary risks associated with verifying compliance with the *Ontario Corporations Tax Act* and contained recommendations for enhancing audit selection tools. The Ministry advised us that the recommendations were approved for implementation and are to be adopted through a phased-in approach.

The Ministry further advised us that, in accordance with a risk-based approach, a broader range of corporations is now being selected for audit. The Ministry has also created a new Audit Control and Analysis Unit that has responsibility for planning, setting, and monitoring audit coverage targets.

Discretionary Field and Desk Audits—Audit Work Completed

Recommendation

To ensure that all necessary audit work is completed satisfactorily and that the work performed clearly establishes whether or not taxes owed have been correctly declared, the Ministry should ensure that:

- *auditors identify and assess all potential risks of non-compliance by the corporation selected for audit and identify and prioritize all the audit work that needs to be performed;*
- *where reliance is to be placed on the work performed by the Canada Customs and Revenue Agency (CCRA), it obtains the necessary information about the CCRA audit activities to provide assurance that such reliance is justified;*
- *auditors use detailed audit programs that clearly indicate the nature and extent of audit work proposed and actually performed; and*
- *managers adequately document their input at the planning stage of an audit as well as their review and approval of the work performed.*

Current Status

As well as being responsible for planning, setting, and monitoring audit coverage targets, updating audit manuals, and setting audit documentation standards, the Ministry's new Audit Control and Analysis Unit is to develop audit programs and provide technical training to all corporations tax audit staff, including those in the regional tax offices.

We were advised that where reliance is placed on audit work performed by the Canada Revenue Agency (CRA, formerly the Canada Customs and Revenue Agency) for a specific file, ministry auditors now review CRA working papers. They then document the relevant findings in their working papers to support their audit conclusions and any corresponding Ontario tax assessment. We were also advised that the Ministry has consulted with and continues to work with CRA on its competent authority process to deal with transfer pricing and related party transactions for Ontario-based corporations.

The new Audit Control and Analysis Unit also developed and implemented a new audit checklist in spring 2003 that managers are now required to complete for each audit file to provide evidence of their review of the file. Completion of the checklist will ensure that:

- audit standards are adhered to; and
- documentation is provided showing that the audit meets the planned scope and addresses all areas identified as high risk.

Also, auditors are now required to create an audit plan, which must be reviewed by their manager.

We were also informed that the Corporations Tax Branch has conducted a number of workshops that addressed the enhancement of audit working papers. A sub-committee of audit managers from all offices is to review existing working-paper standards and prepare enhanced standards for implementation in all corporations tax audit offices.

Nominal Desk Audits

Recommendation

To ensure that provincial corporations tax assessments and reassessments resulting from federal assessments or reassessments are issued on a timely basis and do not become statute barred, the Ministry should ensure that it reviews all federal corporations tax assessments and reassessments and completes any required audit work to determine provincial corporations tax applicability on a timely basis.

Current Status

We were informed that additional desk audit staff had been assigned to work on the backlog of federal assessments and reassessments. We were also advised that a two-tiered approval system for nominal desk audits was implemented in November 2002 to increase the efficiency of reviewing corporations' federal assessments and reassessments, as well as other returns assigned for auditing. The Ministry informed us that with these measures, the backlog of federal assessments and reassessments had been reduced by 47% between May 2002 and January 2004 and that the timeliness of completing the required reviews had improved.

TRAINING NEEDS

Recommendation

To help enable field and desk auditors to effectively and consistently address corporations tax issues and thereby improve tax collection efforts, the Ministry should:

- *ensure that sufficient training that adequately addresses both technically complex issues and industry-specific high-risk areas is provided for both field and desk auditors; and*
- *consider funding, on an individual basis, training initiatives that would increase the individual auditor's knowledge base.*

Current Status

In 2003, the Ministry committed to delivering five days of formal technical training per year to corporations tax audit staff. We were informed that in the 2003/04 fiscal year: seven-and-a-half days of training were provided for new and existing desk audit staff; 10 days were provided to new field audit staff; and five-and-a-half days were provided to existing field audit staff. According to the Ministry, the technical training unit established in 2002 continues to enhance, develop, and deliver technical training materials identified in the job-specific training plans developed for corporations tax audit staff. The unit is also responsible for updating the technical training materials for specialty audits in the areas of insurance companies, financial institutions, oil and gas corporations, and mining corporations. We were informed that the unit—initially funded and staffed on a temporary basis—now has permanent funding in place.

TAX ADVISORY SUPPORT

Recommendation

To provide good taxpayer service and effectively utilize audit resources, the Tax Advisory Unit of the Corporations Tax Branch of the Ministry should:

- *establish a standard completion time for formal requests for tax advisory services;*
- *address all formal legislative and interpretational requests from regional tax offices within the standard completion time established; and*
- *summarize and, where warranted, communicate all tax appeals decisions to all relevant parties in the appropriate manner and on a timely basis.*

Current Status

The Ministry confirmed that a 90-day turnaround time for resolving taxpayer requests for legislative interpretations and rulings—which it believed to be reasonable in our 2002 audit—is achievable in the majority of cases. It also indicated, however, that some requests cannot be completed in 90 days due to their complexity.

To improve response times, all vacancies in the Tax Advisory unit were filled by late 2003. In addition, according to the Ministry, managers are now reviewing assigned inventory and following up with staff on a monthly basis in order to prioritize and resolve requests that have been outstanding for an unusually long period. The Ministry also indicated that—since August 2003—the unit has been summarizing significant tax appeals decisions and is developing a process for communicating the decisions to all relevant parties.

TAX GAP

Recommendation

To help ensure the achievement of its objective of encouraging the highest possible degree of voluntary compliance from taxpayers and thereby reducing the tax gap, the Ministry should conduct research into the areas contributing to the tax gap and direct the necessary resources to minimize the tax loss.

Current Status

The Ministry informed us that it has been in contact with staff at the Internal Revenue Service (IRS) in the United States for information on a promising new methodology they are working on.

The latest IRS approach to estimating the income tax gap uses compliance and other data from a group of audited taxpayers to extrapolate compliance patterns among unaudited tax filers in a given year. IRS staff have noted that this approach is still in a developmental stage. This new methodology is data intensive, requiring very detailed information about the tax returns that have been audited. Such data has not been obtained in Ontario, but the Ministry indicated that it plans to gather such data in the future if sufficient staff resources become available. Once a database of such information exists, the Ministry intends to try to apply the IRS's approach.

The Ministry informed us that it will continue to monitor the research being done in this and other areas. It emphasized, however, that the science of estimating the tax gap is inherently inexact.