Chapter 3
Section
3.13

Ministry of Revenue

Retail Sales Tax Program

Background

The *Retail Sales Tax Act* (Act) imposes a general sales tax of 8% on the retail price of most goods and services sold to final consumers in Ontario. The Act also levies sales tax at variable rates between 5% (for example, on room rentals lasting less than one month) and 12% (for example, on alcoholic beverages).

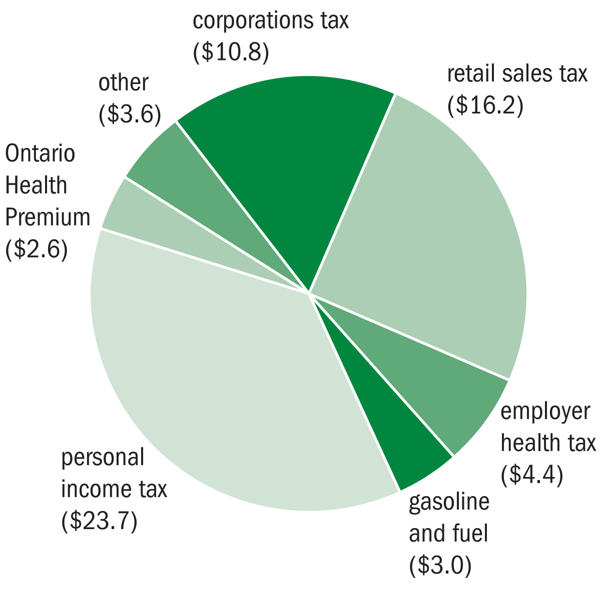
The Act also provides for a number of tax exemptions meant to reduce tax regression or to promote economic or social objectives. Examples of such tax exemptions include sales of children's clothing, equipment designed for use by people with disabilities, and goods purchased by Status Indians under certain conditions.

As at March 31, 2007, approximately 420,000 vendors were registered to collect and remit retail sales tax (RST) to the province. RST receipts for the 2006/07 fiscal year totalled approximately $16.2 billion, net of $153 million in refunds, which represents 25% of the province's total tax revenue. Figure 1 compares RST revenue amounts to the amounts from the province's other sources of tax revenue in the 2006/07 fiscal year.

RST revenues have increased steadily over the last 10 years, as shown in Figure 2.

Figure 1: Total Provincial Tax Revenues, 2006/07 ($ billion)

Source of data: Ministry of Revenue



Staff in the former Retail Sales Tax Branch had primary responsibility for administering the RST program up to the end of the 2004/05 fiscal year. During the 2005/06 fiscal year, the Ministry of Revenue (Ministry) started a process of restructuring whereby all Ontario tax statutes are to be administered through the following seven functional branches:

- Client Accounts and Services;
- Tax Compliance and Regional Operations;

- Tax Appeals;
- Tax Advisory Services;
- Strategic Management Services;
- Special Investigations; and
- Revenue Collections.

Audit Objective and Scope

The objective of our audit was to assess whether the Ministry has adequate systems and procedures in place to ensure that RST owing on taxable sales of goods and services was being collected and remitted to the province in accordance with statutory requirements.

The scope of our audit work included a review and analysis of relevant ministry files and administrative procedures, as well as interviews with appropriate staff at the various functional branches that now administer the RST program. We also met with senior staff at the Office of Economic Policy to obtain an understanding of the magnitude of the underground economy and its effect on the collection of RST.

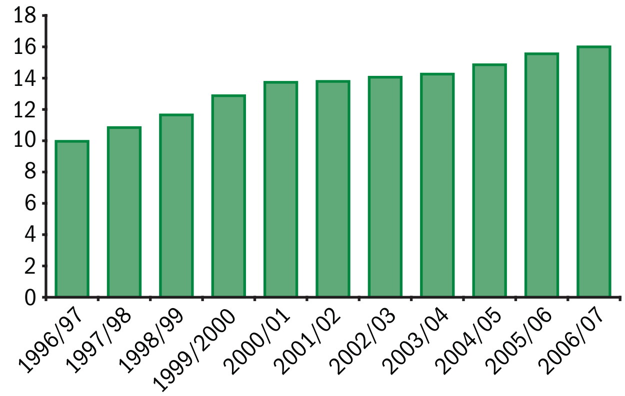
Prior to the commencement of our fieldwork, we identified the criteria we would use to address our audit objective. These criteria were reviewed and agreed to by senior ministry management.

Our work emphasized the procedures in place with respect to RST revenues processed in the 2006/07 fiscal year. Our audit was conducted in accordance with the standards for assurance engagements encompassing value for money and compliance established by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In order to focus the scope of our audit, we reviewed a report issued by the Ministry of Finance's Internal Audit Services in 2003 that assessed the current status of the recommendations made in our *2000 Annual Report*. We also reviewed Internal Audit Service's most recent reports and supporting working papers with respect to accounts receivable written off and the processing of monthly RST returns, and found that they could be relied on. Accordingly, we excluded these areas from our audit.

Figure 2: RST Revenues, 1996/97–2006/07 ($ billion)

Source of data: Ministry of Revenue



We note that the Ministry is currently in the process of replacing its management information system for the administration of all tax statutes and is developing a new information system for use in enforcing tax compliance and collection. Since both systems are expected to be implemented in early 2008, our audit did not include an in-depth review of the management information system currently in place for administering the RST program.

Summary

A number of our observations and findings in this report are similar to those outlined in our last audit of RST in 2000. Although the Ministry (at that time, the Ministry of Finance) generally agreed with our recommendations and committed to taking the necessary corrective action, it also indicated that improvements in its management information systems were necessary to address some of our recommendations. However, the required improvements, which were under development at the time of our audit, have not yet been implemented. The enhanced information that such technology improvements can provide, along with certain improvements in the audit and collection processes, are all necessary before the Ministry can have adequate assurance that RST is being collected in accordance with statutory requirements. More specifically, we noted the following:

- While the Ministry has implemented certain measures to identify non-registered vendors at their places of business or at points of sale, procedures are not yet adequate to ensure that all Ontario vendors—particularly new vendors—selling taxable goods and services are registered with the Ministry for inclusion in the tax roll. The Ministry advised us that it had met with the Ministry of Government Services in summer 2007 and was in the process of negotiating a Memorandum of Understanding to obtain business registration data every six months.
- Although the Ministry has an agreement with the Canada Border Services Agency to collect provincial sales tax for goods entering Ontario from outside the country, no similar mechanisms exist with other provinces with respect to interprovincial trade.
- Since our last audit of the RST program in 2000, the Ministry has undertaken a number of initiatives designed to reduce the tax gap, and planned improvements to its information technology system will allow it to better monitor its progress in this area.
- The audit selection process suffered from a number of deficiencies, including the following:
  - The auditable tax roll used for selecting vendors for audit excludes many vendors registered in Ontario, such as those registered for less than two years and those that designate themselves as part-time.
  - No standardized province-wide criteria have been developed for selecting vendors for audit on the basis of the risk of non-compliance, despite the Ministry's previous commitments to do so.
  - While improvements in audit coverage had been made since our last audit in 2000, the Ministry's coverage of each of its three categories of vendors based on level of sales and amount of tax remitted was still below its targets. As well, the selection of vendors for audit has neglected many profile codes that categorize vendors by industry segments and other characteristics.
- The Ministry was unable to locate 7% of the audit working-paper files that we selected for our review; in 2004, the Ministry's own quality-control review was unable to locate 25% of the files it asked for. These paper files are prepared for review and approval by audit managers before an assessment of taxes owed can be issued. In addition, although the sample of assessments we reviewed had adequate support, the overall documentation in the working papers was often insufficient to demonstrate that all required audit work was adequately planned, completed, and reviewed.
- To encourage future voluntary compliance, ministry policy stipulates that penalties are to be levied on vendors who remit an incorrect amount of RST due to neglect, carelessness, wilful default, or fraud, unless the reasons for not doing so are clearly documented. However, for approximately 20% of cases we reviewed where a penalty could have been applied, the reasons for not applying the penalty were not documented.

- The average number of annual sick days taken by the sample of about 80 auditors we reviewed was approximately 13, as compared to the Ontario Public Service average of about 10 days.

With respect to the collection of outstanding receivables, we found the following:

- Outstanding accounts receivable increased to $967 million as at December 31, 2006, from $587 million at the time of our last audit in 1999/2000, an increase of approximately 65%. In contrast, in the same period, RST revenues increased to approximately $16.2 billion from $12.6 billion, an increase of 29%. The Ministry did not have sufficient procedures in place to assess the level of outstanding receivables and the reasons for significant changes, or identify the corrective action needed.
- The Ministry's current information system does not have the ability to identify accounts receivable for priority collection. Our review of a sample of open collection files found that it often took a number of months for a collector to initiate contact on a file, and approximately one-quarter of files had no collection activity for periods exceeding two years.
- At the time of our audit, approximately 35,000 vendors with active accounts were in default in filing their returns. Of those we reviewed, over eight months elapsed, on average, between the referral of the account to the Ministry's Non-Filer Unit and the compliance officer's attempt to contact the vendor. After the initial contact, many files had an extended period of inactivity.
- For the 2005/06 fiscal year, 130 cases were referred to the Special Investigations Branch, which investigates tax evasion, fraud, and other serious tax offences. Half of these cases were not investigated, and we were informed that this was due to staffing limitations.

The Ministry has been aware of many of the above-noted issues for some time—it has informed us that it believes that its new information systems should allow it to deal with these issues and in doing so will enable it to act fully on many of the recommendations in this report.

We sent this report to the Ministry of Revenue and invited it to provide responses. We reproduce its overall response below and its responses to individual recommendations following the applicable recommendation.

OVERALL MINISTRY RESPONSE

The Ministry of Revenue appreciates the audit observations and recommendations made by the Auditor General regarding the administration of the Retail Sales Tax (RST) program. These observations and recommendations have served in many cases to validate the direction of the Ministry and also point out potential areas to be addressed as the Ministry strives to achieve its goal of becoming a world leader in tax administration.

The Ministry especially appreciates the timing of this audit since, from the date of the last audit in 2000 the Ministry has reassigned the majority of responsibility for the RST program into the respective functional branches. In addition, the Ministry is currently undertaking a number of initiatives to better provide service to vendors/taxpayers and administer taxes more effectively and efficiently.

The primary focus of these initiatives is replacing the majority of legacy systems for the tax programs. The first program to be migrated is RST, expected in December 2007. This integrated tax system will provide a single point of access to facilitate client interaction with the Ministry, enable the authorized sharing of information, and enhance efficiency and effectiveness. The Ministry is also in the process of acquiring a business intelligence tool to perform automated risk-based selection for audit and automated credit risk management for collections. The intent of these initiatives is to more effectively and efficiently identify non-compliant entities, target audit activities on those taxpayers assessed as higher risk of being non-compliant based on specified risk criteria, reduce the number of nil audits, enhance recovery on audits, improve the rate of collections, and ease the burden on compliant taxpayers.

The Ministry agrees to address the recommendations made by the Auditor General and to incorporate them into the business strategies of the appropriate functional areas.

Detailed Audit Observations

OVERVIEW OF PROGRAM

The Ministry's objective in administering the collection of RST is to encourage broad-based, voluntary compliance and, where necessary, to enforce compliance in order to maintain equity and public confidence in the fairness of the tax system. Although, as noted previously, the RST program is now administered through the Ministry's various functional branches, the staff dedicated to the RST desk and field audit function have increased substantially since our last audit and now number approximately 680.

All vendors selling taxable goods and services must be registered with the Ministry and have available their RST permit at their place of business. The vast majority of the tax is collected by approximately one-third of the registered vendors who are required to file a monthly RST return and remit the return and sales tax collected before the 23rd day following month end.

Sales tax returns and remittances may be dropped off at any ministry or Service Ontario office or mailed directly to the Ministry's Revenue Operations and Client Services Branch in Oshawa. They may also be submitted electronically through the Internet or by payment at a financial institution. Approximately one half of the returns received are submitted electronically and one half are submitted in paper form.

Tax Roll Maintenance

Having a complete and accurate tax roll of all vendors selling taxable goods and services is the essential first step in effectively administering the RST program and ensuring that the correct amount of RST is remitted to the province.

Our *2000 Annual Report* identified two areas of concern with respect to the Ministry's ability to ensure the completeness and accuracy of the tax roll.

- The Ministry did not have adequate procedures in place to ensure that potential new vendors selling taxable goods or services (other than those who registered through Ontario Business Connects) were added to the tax roll when they were incorporated or otherwise registered to operate in Ontario. Instead, the Ministry relied on new businesses to register voluntarily if they intended to sell taxable goods or services in Ontario.

At the time of our 2002 follow-up, the Ministry indicated that it had made contact with the then Ministry of Consumer and Business Services to explore opportunities to match the business names registry with the RST database. The Ministry hoped to obtain the necessary data and match it before the end of the 2002/03 fiscal year.

However, as of March 2007, the linkage of the Ministry of Government Services business names registry with the RST database had not been achieved. The Ministry advised us that it would incorporate a function into its new management information system that would make it easier to match data in the different databases. It now expects the system to be operating by early 2008.

- The Ministry needed to strengthen its procedures for regularly identifying non-registered vendors at their places of business or at points of sale.

As a result of our 2000 report, the Ministry implemented a number of initiatives to identify non-registered vendors at their places of business or at points of sale through flea-market blitzes, Internet and Yellow Pages searches, and the like. The Ministry informed us that in the 2006/07 fiscal year it had identified approximately 500 non-registered vendors through these initiatives.

We also note that the amount of commerce conducted through the Internet has been increasing substantially, and much of that commerce is conducted across national and provincial borders. Where taxable goods are purchased from outside Ontario by mail-order or through the Internet, the Ministry has an agreement with the Canada Border Services Agency to collect provincial sales tax for taxable goods entering Ontario from outside the country. However, no similar mechanisms exist with other provinces with respect to interprovincial trade. In these cases, the onus is on the purchaser to declare and remit the appropriate tax for taxable goods purchased from vendors in other provinces and shipped to and consumed in Ontario. We understand that the Ministry has asked the taxation authorities in other provinces to provide it with invoice details that they obtain during their audits for goods purchased in their jurisdictions and shipped to Ontario. However, this is not done routinely, and in any case it is not a practical means to ensure that all tax has been collected from interprovincial trade.

RECOMMENDATION 1

To help ensure that the tax roll for vendors that sell taxable goods and services is complete and accurate and that the appropriate amount of tax is remitted, the Ministry of Revenue should:

- ensure that it can match the government's business names registry with its new management information system—which would allow it to follow up with businesses that are on the names registry but not the RST vendor database; and
- at future meetings relating to inter-provincial taxation, raise the possibility of reciprocal tax collection agreements with other provinces whereby all provincial sales taxes are collected at the point of sale and remitted to the province where the taxable goods are ultimately shipped and consumed.

MINISTRY RESPONSE

It is also important to recognize that many businesses that register with the Ministry of Government Services do not meet the criteria to register for an RST vendor permit. Nevertheless, from time to time, the Ministry has sampled registrants on the Ministry of Government Services' business-names registry to determine if there are businesses that should be registered for RST. These database matches have had limited success.

The Ministry is committed to working closely with the Ministry of Government Services to align business modernization initiatives. While it is not anticipated that the business-names registry will be electronically linked with the Ministry's new management information system, the Ministry will continue to explore feasible opportunities to identify businesses registering with the Ministry of Government Services that require registration under the *Retail Sales Tax Act*.

Furthermore, the Ministry will work with the Ministry of Finance to assess the constitutional and operational viability of, as well any privacy issues relating to, inter-provincial reciprocal tax collection agreements and may use the annual inter-provincial tax conference to explore the possibility of using reciprocal tax collection agreements with other provinces.

TAX GAP

The "tax gap" refers to the amount of RST that is due to the province but is never remitted. The tax gap results primarily from both registered and unregistered vendors that either do not charge tax on taxable sales or that collect tax but do not remit it to the province. Although the nature of the tax gap is difficult to identify and its amount is difficult to quantify, it is generally thought to be significant and attributable to the underground economy.

In our *2000 Annual Report,* we recommended that the Ministry conduct the research necessary to identify significant aspects of the underground economy and focus its compliance and enforcement efforts accordingly. We are pleased to note that the Ministry has undertaken a number of initiatives with respect to the tax gap, including:

- having a senior staff member chair a federal-provincial inter-jurisdictional committee that deals with various issues with respect to the underground economy;
- developing the Responsible Citizenship and Canada's Tax System program, which is a learning package used by teachers to educate students in the importance of being good citizens from an early age;
- co-ordinating information exchange with the Ministry of Transportation on private vehicle sales; and
- obtaining information from inspectors at the Ministry of Labour that helps to focus audit selections.

In addition, in response to our recommendations in both 1995 and 2000, the Ministry also committed to developing and monitoring various performance indicators to assess its progress in identifying and reducing the tax gap. The Ministry expects that the new information technology system that is scheduled to be implemented in early 2008 will greatly improve its ability to deliver on its previous commitments in this area.

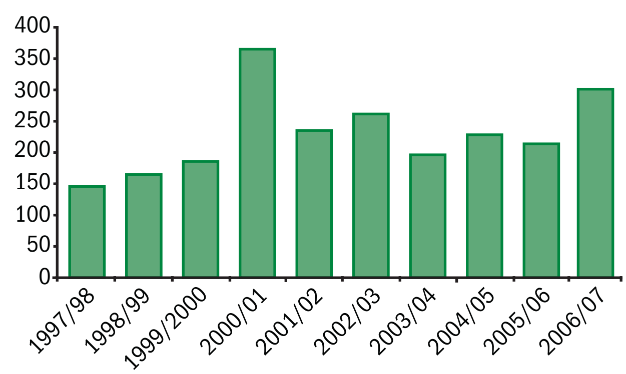
ENFORCEMENT: RST AUDITS

The Ministry has approximately 500 field auditors who in most cases conduct audits independently at the vendor's place of business. The objective of the audits is to determine whether selected vendors have remitted the correct amount of tax owed and to encourage voluntary compliance in the broader vendor community. For administrative purposes, auditors are organized into teams of eight to 10 who report to an audit manager. In turn, audit managers are responsible for overseeing all aspects of work conducted by their auditors as well as for various administrative functions such as approving monthly time sheets.

The total value of assessments of taxes owed resulting from all audits has varied over the last 10 years, as shown in Figure 3. Over this same time

Figure 3: RST Assessments, 1997/98–2006/07 ($ million)

Source of data: Ministry of Revenue



period, RST assessments have ranged from 1.3% to 2.6% of total RST collected.

Auditable Tax Roll

Although any vendor can be selected for audit by an audit manager, audit managers advised us that their practice is to not routinely select vendors for audit that are not included in the auditable tax roll within their geographical area. The auditable tax roll as currently defined excludes approximately 130,000 vendors that have been registered with the Ministry for less than two years and approximately 50,000 vendors who have designated themselves to be part-time. In that regard we note that many vendors designated as part-time had sales exceeding $1 million a year and in one case as high as $42 million.

In our view, excluding these vendors from the regular audit selection process is questionable because:

- being in business for less than two years is not an indication of lower risk to the Ministry—in fact, the opposite may be true; and
- there is no clear definition of part-time vendors, and vendors designate themselves as part-time without any verification by the Ministry.

RECOMMENDATION 2

In order to ensure that potentially high-risk vendors are not systematically excluded from audit selection, we encourage the Ministry of Revenue to revise its audit selection process to include both newly registered and part-time vendors.

MINISTRY RESPONSE

We agree with the Auditor General's recommendation. The new information technology system, which is expected to be implemented in late 2007, will incorporate all vendors into the auditable tax roll, including those registered with the Ministry for less than two years and those designated as part-time.

Audit Selection

Selecting the right vendors for audit is critical for ensuring that the Ministry meets its goals of ensuring that the correct amount of tax is remitted to the province and of encouraging voluntary compliance in the broader vendor community. In that regard, we note that as far back as 1995, the Ministry indicated that it would develop standardized risk-based criteria for selecting vendors for audit.

However, there is still no province-wide system in place for selecting vendors for audits based on assessed risks or other factors. Instead, individual audit managers select vendors on the basis of their own judgment from a list of vendors assigned to them. Our review of the audit selection process for a sample of managers found the following:

- The criteria used to select audits varied among managers and therefore were not consistent across the province.
- There is no process to analyze or otherwise oversee managers' audit selections to ensure that they meet the Ministry's objectives. In that regard, we found that results varied significantly by manager. For example, for the 2005/06 fiscal year:
  - while overall approximately one in three audits did not result in any adjustments to taxes payable, nil assessments varied from a low of 14% for one audit manager's team to a high of 60% for another audit manager's team; and
  - while the overall average assessment for all small vendor audits was approximately $283 per audit hour, individual managers' team assessments ranged from a low of $110 to a high of $734 per audit hour.

The Ministry engaged a consultant to review its risk assessment and audit selection methodology. The review included a comparison of this methodology with industry-standard best practices. The consultant's report, which was issued in December 2004, made a number of recommendations, including the need to:

- centralize the audit selection function and centrally manage audit pools; and
- automate the risk-assessment process using evidence-based criteria that are continuously updated and consistently applied.

The consultant noted a number of jurisdictions and agencies, including the Canada Revenue Agency, British Columbia, Michigan, and Florida, that had developed centralized, automated risk assessment systems. The benefits of implementing such systems included:

- the use of dedicated audit selection staff to allow more time for managers to address other audit issues;
- tiered audit pools based on risk of taxpayer non-compliance, with high-risk audits receiving priority status;
- increased audit recoveries, at least in one case with fewer audit hours; and
- significant overall decreases in nil assessment rates.

We understand that the Ministry has established a Risk Assessment and Workload Development Unit, which is currently assisting in the development of an automated, centralized evidence-based risk-assessment system for selecting vendors for audit. This system is expected to be operating in early 2008.

We also found that during the 2006/07 fiscal year, the Ministry processed approximately 27,000 refund claims totalling approximately $186 million, of which 954 claims totalling $57.5 million were refunded "subject to audit." The Ministry's Audit Handbook requires that a number of refunds identified as subject to audit be audited every year, although the number to be audited is not specified. In practice, refunds have not been incorporated in the managers' audit selection process, but may be reviewed if a vendor is otherwise selected for audit. A one-time ministry review of refunds issued subject to audit in 2006 found that approximately 10% of refunded amounts were disallowed.

RECOMMENDATION 3

To help ensure that it meets its goals of ensuring that the correct amount of tax is remitted to the province and of encouraging voluntary compliance in the broader vendor community, the Ministry of Revenue should:

- complete the development of an automated, centralized evidence-based risk-assessment system for selecting vendors for audit and implement it as soon as possible; and
- specify the approximate number or percentage of higher-risk refunds issued subject to audit that are to be audited each year and ensure that the audits are carried out.

MINISTRY RESPONSE

The Ministry is in the process of working with the successful proponent to develop a business intelligence tool to support automated risk-based audit selection. We expect this tool to be functional in 2008.

The Ministry will establish documentary criteria to ensure there is a strategy in place for auditing each year a representative sample of refunds issued that are subject to audit.

Audit Coverage

Maintaining adequate and representative audit coverage is also essential to the Ministry's objectives of collecting the correct amount of tax owed and encouraging voluntary compliance with the RST.

The Ministry has established audit coverage goals for each category of vendor (small, medium, and large). Since the time of our last audit in 2000, the Ministry's audit coverage in each of the three categories has increased substantially, and the Ministry has been successful in increasing its recoveries per audit hour, as shown in Figure 4.

However, the Ministry's audit coverage in each of its categories was still below its goals, with the result that significant potential audit recoveries were likely forgone. For example, in May 2005, the Ministry estimated that it was forgoing approximately $25 million annually in revenue recoveries from not meeting its audit coverage goal for large vendors alone.

As a result, the Ministry hired an additional 120 auditors during 2005 and 2006, and we have been informed that it expects to meet its audit coverage goals for all three categories of vendors in the 2008/09 fiscal year.

All vendors are assigned to one of approximately 300 profile codes that categorize vendors by industry segments and other characteristics. Among other things, the Ministry uses these groupings to help ensure that vendors selected for audit come from a broad spectrum of the tax roll. We note that the number of profile codes in use has doubled since the time of our last audit in 2000.

Our review of audit coverage by industry profile code found that:

- for the 2005/06 fiscal year, no audits were conducted on any vendors from almost one-half of the profile codes;
- for the last four fiscal years, no audits were conducted on any vendors from approximately 15% of the profile codes; and
- the distinction between some of the 300 profile codes could not be explained to us.

RECOMMENDATION 4

To ensure that all vendors are given due consideration for audit selection and to encourage voluntary compliance through an adequate and representative level of audit coverage, the Ministry of Revenue should:

- continuously monitor its audit coverage for all three vendor categories and endeavour to meet its audit coverage goals for each as soon as possible;
- select audits from all segments of the vendor population; and
- facilitate the audit selection and results assessment process by reducing and more clearly defining the number of different vendor profile codes it uses.

MINISTRY RESPONSE

The Ministry's strategy is to ensure its largest vendors are audited on a three-and-a-half-year cycle. Staffing was secured in 2005 to achieve this commitment. It is expected that this cycle will be achieved by the third quarter of the 2008/09 fiscal year.

As the Ministry moves to selection based on risk, a review will be undertaken to determine appropriate coverage/staffing levels to balance potential audit recoveries identified from the risk-based selection system with geographical and taxroll coverage priorities.

The Ministry is in the process of moving its categorization of its taxroll from profile codes to North American Industry Classification System codes, which will provide for greater delineation and be consistent with the Canada Revenue Agency (CRA). This will facilitate more focused selection and exchange of information with the CRA.

Figure 4: Audit Hours Spent and Assessments Issued by Vendor Category, 2006/07 vs. 1999/2000

Source of data: Ministry of Revenue

Vendor Category	Auditable Tax Roll as of March 31, 2007	Total Audit Hours 2006/07	Total Audit Assessments 2006/07 ($ million)	Assessment per Hour 2006/07 ($)	Assessment per Hour 1999/2000 ($)
large	207	166,313	175.7	1,056	865
medium	11,864				
small	212,051	297,841	123.4	414	290
Total	**224,122**	**464,154**	**299.1**	**644***	**437***

*overall average

Audit Working Papers

Although many working papers are prepared and stored electronically, paper files, including copies of supporting documents, must be prepared for review and approval by an audit manager before an assessment of taxes owed can be issued.

This requirement notwithstanding, the Ministry was unable to locate 7% of the working paper files in cases for which assessments were issued that we selected for our review. Similarly, we noted that when the Ministry's own Internal Quality Assurance Unit conducted a quality control review in 2004 (the most recent review for which information was available at the time of our audit), 25% of the files it asked for could not be located.

The risks associated with misplacing audit working paper files include the possibility that:

- confidential information regarding a vendor may fall into the wrong hands; and
- taxpayer objections and appeals may succeed in large part due to the lack of supporting documentation that the Ministry can provide.

For the sample of files that we reviewed, we found that the assessments that were issued were adequately supported with sufficient and appropriate documentation. However, we did identify areas in need of improvement:

- In many cases, there was a lack of evidence of managerial input during the planning phase of an audit or of managerial approval of the work to be undertaken, as required by the Ministry's Audit Handbook.
- Although in most cases auditors use standardized audit programs, documentation was often insufficient to demonstrate that all the necessary work had been performed.
- In most cases, completed audit files lacked evidence of managerial review of the underlying work performed, such as review notes or initials on working papers.

RECOMMENDATION 5

To help ensure that the confidentiality of taxpayer information is maintained and provide evidence that audits have been adequately planned and conducted, the Ministry of Revenue should ensure that:

- all audit working paper files are securely stored and available for review; and
- audit working paper files contain the documentation necessary to demonstrate that all required work has been adequately planned and completed, and reviewed and approved by an audit manager.

MINISTRY RESPONSE

With the current technology being used in the RST audit program, all audit working papers are available electronically and can be used to support the basis of all assessments. When the Ministry migrates to its new platform, it is anticipated that the electronic file can be enhanced with the ability to scan source documents. The Ministry is confident that the risk of confidential taxpayer information being compromised as a result of misplaced files is minimal. Nevertheless, the Ministry has constituted an inter-branch committee to review the policies and procedures for the transfer of hard-copy files between offices.

The Ministry also agrees to remind managers of the need to ensure that there is adequate documentation to demonstrate that all necessary work is completed, reviewed, and approved.

Penalties

To deter vendors from remitting an incorrect amount of retail sales tax and encourage future voluntary compliance where instances of non-compliance are detected, the *Retail Sales Tax Act* provides for the imposition of a 25% penalty when an audit determines that the correct amount of sales tax was not remitted due to neglect, carelessness, wilful default, or fraud on the part of the taxpayer. In addition, the Ministry's Audit Handbook states that a penalty should be applied in all such instances to ensure that all non-compliance is treated equally, unless the rationale for not applying the penalty is clearly documented and approved by the audit manager.

Although audit assessments have increased substantially since the time of our last audit in 2000, the amount of penalties applied has actually decreased over the same period from approximately $6 million in the 1998/99 fiscal year to $5.3 million in the 2006/07 fiscal year. Our review of a sample of audit working paper files where an assessment was issued and a penalty could have been applied but was not applied found that, in approximately 20% of the cases, the reasons for not applying the penalty were not documented as required and therefore not clear. Some of the potential penalties forgone were significant. For example, a penalty of $3.7 million was not applied on an assessment valued at $14.8 million, with no documented explanation. We also noted that while some audit managers never applied the penalty, other audit managers imposed the penalty for up to 10% of their audits where an assessment was issued, which raises issues of equity and fairness.

RECOMMENDATION 6

In order to deter taxpayers from remitting an incorrect amount of tax, the Ministry of Revenue should comply with its policy that penalties be imposed in all cases where an assessment was issued due to the taxpayer's neglect, carelessness, wilful default, or fraud, unless the reasons for not doing so are clearly documented and approved by the audit manager.

In addition, in cases involving the potential imposition of a significant penalty (that is, exceeding a predetermined threshold amount), the Ministry should assess the merits of having more senior staff review the case and decide whether or not to impose the penalty.

MINISTRY RESPONSE

The Ministry agrees that the penalty is to be applied as a deterrent to vendors who under-remit RST and that in some cases there was insufficient documentation to substantiate why the penalty had not been applied.

The Ministry agrees to review its policy to determine the merits of having larger penalties reviewed by more senior staff.

Monitoring of Audit Staff

Hours of Work

Auditors' terms of employment, including hours of work, are governed by the Ontario Public Service Employees Union collective agreement as well as by ministry policies and procedures, which, among other things, contain the following provisions:

- The standard workday is 7¼ hours, although auditors are permitted flexible work hours without prior manager approval. Where overtime is worked, they can bank up to 36¼ hours (or more with manager pre-approval) and take this time off at a later date or be in a deficit of (that is, owe the Ministry) up to 14½ hours at any point in time.
- Auditors' work time commences upon leaving their home or office and includes time for returning to their home or office at the end of the day.
- A medical certificate must be supplied for all sick leave absences that exceed five consecutive working days. Where employees are absent more than 10 days in a year, they are subject to the Ministry's Attendance Support Program, which starts with a formal interview designed to identify the issues leading to absenteeism, attendance improvement goals, and the need for support.
- Auditors return to their office on the first working day following the end of the month to submit their timesheets and perform other administrative functions.

Our review of the detailed time records of 10 audit teams, comprising approximately 80 auditors, for the 2006/07 fiscal year noted the following:

- Sick days for all auditors in a team averaged from six to 24 days a year, with an overall average of about 13 for all auditors. This compares to the Ontario Public Service average of about 10 sick days per year.

  Our review of a sample of personnel files for individuals who had between 12 and 25 sick days during calendar year 2006 found only one instance where there was any evidence that a formal interview, to discuss the issues leading to absenteeism, attendance improvement goals, and the need for support, as required under the Attendance Support Program, was actually held.
- Approximately one in four auditors reviewed exceeded the maximum borrowed time allowed at some point during the year. The average excess deficit for these employees was 10 hours, and in one case it was as high as 40 hours in excess of the maximum 14½ hours allowed.

In addition, we reviewed exception reports prepared by the Ministry detailing auditors whose charged travel time exceeded 20% of the time charged to audit activities. We noted that for the three months ended June 30, 2006, there were 79 auditors whose travel time exceeded 20% of their audit time. We were informed that audit managers reviewed and discussed the ministry policy with respect to travel time with these auditors, with the result that the number of auditors whose travel time exceeded 20% was reduced to 47 for the three months ended March 31, 2007.

Audit Assessments per Audit Hour

Another measure of performance in the audit function is the amount of assessments issued per audit hour. We noted that, for all auditors, the average recovery per audit hour by auditor classification varied significantly within classifications, as detailed in Figure 5. We saw no evidence that there had been any formal follow-up of such significant variances to determine what if any corrective action was necessary.

Figure 5: Variation in Assessments per Audit Hour
Source of data: Ministry of Revenue

Auditor Classification	Average Assessment for All Direct Audit Hours ($)	Average Assessment for the Lowest 10% ($)	Average Assessment for the Highest 10% ($)
senior	570	84	1,930
junior	271	39	857
trainees	131	16	375

RECOMMENDATION 7

In order to maximize productive audit hours and resultant audit assessments, the Ministry should:

- investigate the reasons for relatively high absenteeism rates among auditors and take the necessary corrective action;
- ensure that auditors comply with the Ministry's flextime policy and limit time-banking deficits to no more than 14½ hours at any point in time;
- continue to monitor auditors' time charged to travel, with a view to further reducing time charged to travel; and
- identify best practices and other strategies used by those auditors who consistently have high audit recovery rates.

MINISTRY RESPONSE

While respecting individual employees' right to privacy regarding their medical circumstances, we agree that all staff exceeding the ministry threshold must enter the Attendance Support Program. We will ensure all managers are reminded of their obligations pursuant to the policy.

The Ministry commits to undertake a review of its flextime policy to better reflect current workplace trends.

The Ministry commits to continue to review the travel time of its audit staff and will look for opportunities, through new technologies and alternative work arrangements, to reduce travel time.

The Ministry commits to identify and share best practices in audit methodologies with staff to maximize revenue recovery opportunities.

COLLECTION FUNCTION

Outstanding Accounts Receivable

Accounts receivable result primarily from RST assessments issued following an audit and from vendors submitting RST returns without full payment. Outstanding accounts receivable increased substantially to $967 million as at December 31, 2006, from $587 million at the time of our last audit in the 1999/2000 fiscal year, an increase of approximately 65% (before an allowance for doubtful accounts receivable of $459 million for December 31, 2006, and $201 million for 1999/2000). This increase compares very unfavourably with the increase in underlying annual RST revenues for the same period to approximately $16.2 billion from $12.6 billion, an increase of 29%. Details with respect to the length of time in which accounts receivable have been outstanding and the amounts involved are provided in Figures 6 and 7.

Despite the increase in accounts receivable outstanding, the Ministry did not have sufficient procedures in place to assess the reasons for the increase and identify corrective action to be taken. We therefore examined the collections process more closely to identify reasons and possible corrective action.

Collection Effort

Outstanding accounts receivable are assigned to work stacks of individual collectors who are

Figure 6: Outstanding (O/S) RST Amounts by Length of Time Overdue

Source of data: Ministry of Revenue

Length of Time O/S	Amount O/S as at Dec. 31, 2006 ($ million)	% of Total	% at Time of Our Last Audit*
1–90 days	73.5	8	15
91–360 days	141.7	15	20
1–2 years	113.2	12	17
2–3 years	110.1	11	20
3+ years	528.7	54	28
Total	**967.2**	**100**	**100**

* October 31, 1999.

Figure 7: Outstanding (O/S) RST Accounts by Amount

Source of data: Ministry of Revenue

Amount of O/S Balance	# of Accounts	Total Value as at Dec. 31, 2006 ($ million)
$100,000+	1,842	513.9
$25,001–$100,000	5,780	281.9
$5,001–$25,000	11,057	131.1
$1,000–$5,000	14,324	35.1
<$1,000	12,269	5.2
Total	**45,272**	**967.2**

responsible for all aspects of the collection function. Outstanding balances from vendors in certain profile codes that are considered to be at high risk of non-collectibility and outstanding balances over $15,000 are assigned to senior collectors.

The Ministry's current information system does not have the ability to identify accounts for priority collection based on, for example, vendor-specific risk of non-collectibility or potential for collection. Instead, individual collectors have considerable discretion in prioritizing the work effort and the steps to be undertaken, and in practice, collectors generally work accounts in descending order of outstanding amounts. Typically, collectors send letters and make follow-up phone calls which, if unsuccessful, can lead to referral to a field collector or to legal action such as liens, garnishments, or asset seizures.

Our review of a sample of open collection files found the following:

- Although it is generally accepted in the debt-collection industry that immediate contact with the debtor is essential, it often took a number of months from the time a file was assigned to a collector to the time the first attempt to contact the vendor was made.
- Collection activity was often not adequately documented. For example, information with respect to telephone calls, such as who was contacted, what was discussed, and what was agreed to, was in many cases not evident.
- On many files, no collection efforts were undertaken for extended periods. For example, approximately one-quarter of the files had no collection activity for periods exceeding two years.

We also found that in many cases there was no documentation to demonstrate that suggested best practices, such as a personal phone call prior to sending a collection letter, were followed or other requirements such as tax roll updates or confirmation of information on file were met.

We understand that the Ministry is currently in the process of developing a new management information system for the collection function. As part if this process, it hired the services of a consultant to assess the collection function and identify best practices from other jurisdictions and agencies, including the Canada Revenue Agency, the province of British Columbia, and a number of U.S. states. The consultant concluded that:

- early action on accounts was imperative;
- risk scoring of accounts was essential to ensure that more aggressive and targeted action was taken on the accounts with the greatest risk of non-collectibility; and
- those accounts—which are clearly uncollectible—should be written off on a timely basis so that efforts can be spent on accounts having the most promise of collection.

RECOMMENDATION 8

To address the increase in outstanding accounts receivable, the Ministry of Revenue should be more proactive in taking prompt and rigorous collection action and ensure that all collection activity is adequately documented.

MINISTRY RESPONSE

The Ministry acknowledges there are opportunities to improve the timeliness of collection activities. The Ministry notes that, over the approximately five-year period since the Auditor's last audit, there was a net increase of 23% in the active accounts receivable after doubtful accounts were removed. Several initiatives that will improve the Revenue Collections Branch's ability to take rigorous collection action quickly are currently under way. The objective of the Collections Risk Management Project is to prioritize collector workloads based on multiple risk parameters and develop tools to predict taxpayer behaviour. This risk-scoring methodology, scheduled for implementation in 2008, will enable the Revenue Collections Branch to move the right account to the right collector for the appropriate collection action, facilitating prompt, consistent, and progressive collection action.

Overdue Returns and Non-filers

All registered vendors must file a sales tax return no later than the 23rd day following the end of their reporting period whether or not they had any sales or collected any tax during that period. When a vendor is in default of filing the required return for more than 30 days, the Ministry issues a system-generated reminder notice requesting that the vendor file the required return; it issues a second notice, if necessary, from 30 to 60 days after the first notice. If the vendor continues in default, the account is referred to the Non-Filers Unit where a compliance officer will attempt to make telephone contact and may, depending on the estimated tax outstanding, issue an estimated assessment based on the vendor's previous returns and remittances or on remittances from other similar vendors.

As of March 31, 2007, approximately 35,000 vendors, or approximately 8% of all vendors on the tax roll, were in default in filing their required returns. Our review of a sample of vendors with active accounts that had not filed their required returns found the following:

- On average, over eight months elapsed between the time the account was referred to the Non-Filer Unit and a compliance officer attempted to contact the vendor with the longest period being 21 months;
- After the initial contact, many of the files had an extended period of inactivity, ranging from nine to 14 months.

Timely follow-up of vendors in default of filing a return is critical, in our view, because as the time between default and follow-up increases, the chance of receiving the defaulting return and corresponding remittances diminishes.

RECOMMENDATION 9

To give it the best chance of receiving outstanding RST returns and the required remittances, the Ministry of Revenue should ensure that:

- initial contact with defaulting vendors is made on a more timely basis; and
- after initial contact, follow-up with defaulting vendors is made on a continuous and timely basis until the matter is resolved.

MINISTRY RESPONSE

The Ministry agrees that the timeliness of default resolution could be improved. We are currently working on a comprehensive default-resolution strategy and expect that many of the proposed changes will be implemented as part of phase-three implementation of the new information technology system in late 2008. We expect that initial contacts and follow-ups will improve as a result.

SPECIAL INVESTIGATIONS

The Special Investigations Branch investigates all cases of suspected tax evasion, fraudulent grants and tax credit claims, and other serious tax offences that are, in most cases, referred to it by the Tax Compliance and Regional Operations Branch. The Special Investigations Branch is also responsible for the prosecution of cases where sufficient evidence is available to support such action.

For the 2005/06 fiscal year, 130 RST cases were referred to the Special Investigations Branch. Our review of these referrals found that:

- half of the referrals were not investigated—primarily, we were informed, because of staffing limitations rather than the merits of the case; and
- of the 65 cases for which an investigation was completed in the 2005/06 fiscal year, 28 resulted in prosecutions, with fines totalling approximately $860,000.

We also note that where referrals are investigated, the results of the investigation, the reasons for prosecuting or not prosecuting, and the results of the prosecution are communicated to the referring manager. However, this information is not analyzed and communicated to other auditors and audit managers for their consideration in the work they perform.

RECOMMENDATION 10

In order to ensure that all cases that warrant investigation are in fact investigated, and that the results of the investigations and any prosecutions are considered during future audits, the Ministry of Revenue should:

- obtain the level of staff required to ensure that all referrals that warrant investigation are in fact investigated; and
- analyze and, where warranted, communicate the results of investigations and prosecutions to all auditors and audit managers for consideration in their work.

MINISTRY RESPONSE

The Ministry supports this recommendation and has taken steps to fill existing positions. Any additional needs will be considered and requested via the standard process. The Ministry is reviewing its formal report-back process relating to completed investigations and prosecutions in an effort to ensure it is more timely and relevant to its client group. The Ministry has already implemented a procedure where the auditor, audit manager, and relevant director are informed by memo of the results of a court case within two weeks of notification by Legal Services Branch prosecutors.

INTEGRATED TAX COLLECTION AND MANAGEMENT INFORMATION SYSTEM

The need to enhance the Ministry's management information technology systems to more effectively support the administration of all tax statutes was identified as far back as the time of our audit of this program in 1995. For example, in our 1995 report, we identified information, which the BASYS computerized information technology system in use at the time did not produce, that would be useful for the administration of the RST program. At that time, the Ministry indicated that it had an initiative under way to develop a ministry-wide "integrated tax administration system" (ITAS) that was to create a single-taxpayer-based computerized information system for all tax programs administered by the Ministry. RST was scheduled to be transferred to ITAS in early 1997.

However, at the time of this audit, no new information systems have been developed and implemented for administering the RST program, with the result that the BASYS system being used today is the same system that has been in place since the 1970s.

We note that the Ministry is currently in the third year of a six-year development process for modernizing Ontario's systems for tax administration (MOST). By March 31, 2007, the Ministry had spent approximately one-third of the projected $138-million cost of developing MOST. The Ministry anticipates that during the fall of 2007 it will release phase 1 of MOST, which will support the administration of and accounting for RST revenues. The system to support the administration and accounting for Employer Health Tax revenues and the operations of the Revenue Collections Branch are to be implemented in fall 2008. The Ministry expects to obtain a $6 increase in revenue for every $1 spent on the project by the time it is fully implemented in 2010, as well as being able to provide improved customer service.

We will report on the status of the development and implementation of the Ministry's latest information technology system development initiative in our follow-up of the status of our recommendations in 2009 to assess whether the expectations for the new technology systems have been met.