

Employer Health Tax

The *Employer Health Tax Act* requires all employers who have a permanent establishment in Ontario to remit employer health tax (EHT) on total Ontario remuneration paid to employees. The tax is payable in monthly or quarterly instalments or on an annual basis depending on the total annual amount of tax payable. The rates of payment vary from .98% on total remuneration less than \$200,000 up to 1.95% for remuneration in excess of \$400,000. Since January 1, 1993, self-employed individuals resident in Ontario with net self-employment income in excess of \$40,000 have also been required to pay this tax at the same rates as employers. At the beginning of our audit in September 1996, the EHT taxroll consisted of approximately 396,000 private and public sector employers and 54,000 self-employed taxpayers.

The EHT replaced Ontario Health Insurance Plan (OHIP) premiums on January 1, 1990. OHIP premiums had generated about \$1.7 billion in revenue annually compared with the \$2.7 billion generated by EHT during its first full fiscal year. Since that time, EHT revenues have remained relatively stable, with \$2.8 billion collected in the 1996/97 fiscal year of which self-employed individuals paid \$39.5 million.

The Employer Health Tax Branch of the Ministry of Finance has primary responsibility for the Act's administration and enforcement. The Branch operates through a head office and six regional offices. Most of the Branch's 177 staff work in two major areas: audit and taxroll administration. In the 1996/97 fiscal year, the Branch's expenditures were approximately \$11.9 million, of which \$8.5 million, or 71%, related to salaries and benefits.

Remittances and tax returns are processed by the Ministry's Taxation Data Centre. Branch activities are supported by a computer-based system which maintains the EHT database, records remittances, triggers collection activities for delinquent accounts and is a source of information for the selection of tax returns for audit.

The *1996 Ontario Budget* announced legislative changes to the *Employer Health Tax Act* which will exempt private sector employers with payrolls under \$400,000 and all self-employed individuals from paying EHT. Public sector employers are not affected by the changes. The tax exemption is being introduced over three years starting on January 1, 1997. The *1996 Ontario Budget* indicated that while EHT revenues will be reduced by about \$290 million, additional revenue of \$260 million will be generated from the new Fair Share Health Care Levy that has been incorporated into the existing surtax on Ontario personal income tax.

OBJECTIVE AND SCOPE

Our audit objective was to assess whether reasonable procedures were in place to ensure that the Ministry collects the proper amount of employer health tax in a timely manner and in accordance with statutory requirements.

Our audit focused on the two main functional areas within the Employer Health Tax Branch, specifically, audit and taxroll administration. While most of our audit work was conducted at three of the larger regional offices, questionnaires were sent to, and discussions held with, all six regional offices. We were able to reduce the scope of our work at the Taxation Data Centre due to the relevant work done by the Ministry's Audit Services Branch which we reviewed and were able to rely on.

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OVERALL AUDIT OBSERVATIONS

The Ministry considers the audit of tax returns to be the greatest stimulus to encouraging voluntary compliance and minimizing the difference between the amount of EHT collected and the amount that could be collected. Based on the current number of field audit staff and the number of field audits being conducted, we concluded that overall audit coverage was adequate. However, the effectiveness of field audit could be improved by using better information and a more formalized risk-based approach in order to select audit candidates with a high potential for reassessment.

We recommended, and the Ministry is now in the process of starting up, a desk audit function. As well as monitoring the implementation of the new exemption limits, desk audits could also follow up those audit issues which can be dealt with more cost effectively through written correspondence or by telephone contact with the taxpayer. The additional audit revenues generated, together with the greater voluntary compliance resulting from this increased audit presence, will further reduce the difference between the amount of EHT collected and the amount that should be collected.

We concluded that Ministry procedures were adequate to ensure EHT payments were being deposited promptly and credited to the appropriate taxpayers' accounts, as well as ensuring that the approximately 396,000 EHT returns received annually from employers were being processed accurately.

DETAILED AUDIT OBSERVATIONS

AUDIT ACTIVITIES

Audits have a two-fold effect on taxpayers. The immediate effect is that taxpayers have to pay additional taxes if an audit results in the issuance of a reassessment. A second and equally important effect is an increased awareness in the taxpayer community that audits are being

conducted. Consequently, it is important that an adequate level of audit coverage be maintained to ensure that awareness.

Reassessments arising from audits must be issued within four years from the date of the original assessment; otherwise, the return becomes statute barred, which means that it cannot be reassessed unless fraud is suspected.

AUDIT COVERAGE

In late 1993 an EHT field audit function was introduced, and field auditors were hired to conduct audits of taxpayers' records at the taxpayers' places of business. The initial focus was on auditing the 35,000 larger employers with remuneration greater than \$400,000. In 1994 the *Ontario Budget* introduced an EHT relief initiative which contributed to additional audit staff being hired to increase audit coverage of large, complex employers with total revenues greater than \$50 million and remuneration exceeding \$12.8 million. Branch policy stipulates that these large employers are to be audited at least once within each four-year period. The Branch does not routinely audit the 361,000 smaller employers with remuneration of less than \$400,000, and which, in total, contribute about \$150 million, or 5%, of total EHT. In the 1995/96 fiscal year, field audits generated net reassessment revenue of approximately \$16 million.

Of the 35,000 employers with remuneration greater than \$400,000, approximately 2,700 or 8% were audited in the 1995/96 fiscal year. Given current staffing levels and the number of employers currently being audited, the Branch appears to be able to comply with its policy of auditing all large employers with annual remuneration exceeding \$12.8 million within the four-year period prior to their becoming statute barred. Based on these levels of audit coverage and in comparison with the audit coverage levels in the other taxation programs in the Ministry, we believe these are adequate levels of audit coverage.

AUDIT SELECTION

The success of the audit function in recovering unpaid tax is largely dependent on the auditor's ability to select for audit those taxpayers with a higher risk of having underreported their EHT payable. Consequently, a risk-based selection approach which takes into consideration all pertinent information available from the computer-based Integrated Tax Administration System (ITAS) needs to be used. Such information would include the length of time since the last audit, the amount of any previous audit reassessments, large refunds paid, unusual fluctuations in remuneration and the type of business in order to highlight higher risk taxpayers.

We noted that the various regional offices were not consistently using a formal risk-based approach to select taxpayers for field audit as the points below demonstrate.

- Regional office responses to our questionnaire indicated a wide variation in the frequency with which relevant information available from ITAS was taken into consideration in selecting taxpayers for audit.
- In 1995 the Branch processed approximately 31,000 refunds totalling \$60 million, with \$27 million representing 489 refunds greater than \$20,000 each. However, the Branch does not have a system in place to automatically highlight for audit consideration those taxpayers who have received large refunds. Regional office responses to our questionnaire indicated that refunds are generally taken into consideration in selecting audit candidates in only three of the six offices.

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We were also advised by one of the two other provinces collecting a health-related tax that large refunds are considered a key criterion in selecting taxpayers for audit.

- The percentage of audits resulting in reassessments during the 1995/96 fiscal year ranged from 46% to 79% among the six regional offices. We noted that the office with the 46% rate selected many audits on a random basis while the office with a 79% rate selected its audits using a more risk-based approach.
- In one office, the variance in recovery rates per auditor-hour ranged from an annual average of \$22 to \$555 per hour. The auditor with the \$22 average recovery rate was selecting taxpayers randomly from a list sorted by postal code in order of declining remuneration, while the auditor with the recovery rate of \$555 used a risk-based approach which successfully took into consideration a number of different factors. This variance in recovery rates is also indicative of situations that can arise where audit managers delegate the responsibility for audit selection solely to their auditors.

According to the Branch's *Audit Manual*, the reason for selecting a taxpayer for audit should be documented. We reviewed a sample of audits completed during the 1995/96 and 1996/97 fiscal years at three regional offices and noted that only one of the three was consistently documenting these reasons.

Recommendation

In order to maximize the amount of unpaid taxes detected through field audits, the Ministry should consistently apply a risk-based approach that takes into account all pertinent information in selecting taxpayers for audit. Regional audit managers should monitor the selection process and ensure that selection rationales are appropriately documented.

Ministry Response

We agree with the recommendation. Improvements in file selection for audit are part of the Ministry's system development plans targeted for completion by the end of the 1997/98 fiscal year. Analysis of refunds, return amendments and tax relief claims will be one component.

DESK AUDITS

Tax returns can also be audited through a desk audit process. A desk audit is carried out by staff who follow up on inconsistencies or anomalies in the taxpayer's return through written correspondence or telephone contact with the taxpayer. A desk audit generally takes less time than a field audit and, in certain circumstances, is a much more efficient way of auditing taxpayer returns.

At the time of our audit, the Employer Health Tax Branch did not have a desk audit function in place. Most other major tax branches within the Ministry use desk auditors. Additionally, one of the two other provinces that collects a health-related tax advised us it uses desk auditors to follow up on potential issues with taxpayers.

Examples of situations where we believe follow-up by desk auditors would result in good payback for the Ministry are listed below:

- taxpayers who report monthly remuneration throughout the year which, in total, is either significantly greater or less than the total annual remuneration they report on their annual returns;
- taxpayers who report on their T4 Summaries to Revenue Canada significantly higher amounts of remuneration paid than they report on their EHT annual returns;

We noted that in September 1996 the Branch received a tape from Revenue Canada of employer T4 Summary remuneration amounts. However, by the end of our audit fieldwork, this information had not yet been compared to the remuneration these employers were reporting on their EHT annual returns.

- self-employed taxpayers who have declared self-employment income greater than \$40,000 to Revenue Canada but who have not registered with the Ministry;
- self-employed taxpayers who report higher amounts of self-employment income on their federal personal income tax returns than on their annual EHT returns; and
- self-employed taxpayers who have been reassessed by Revenue Canada for underreporting self-employment income.

Toward the end of our audit fieldwork, we were advised that the Ministry had approved the establishment of an EHT desk audit function to monitor the implementation of the new tax exemption beginning in 1997 as announced in the *1996 Ontario Budget*.

Recommendation

To better identify and act on underreported taxes, the Ministry should implement the planned desk audit function and ensure that inconsistencies and anomalies in employer health tax returns that are amenable to desk audit methods are investigated.

Ministry Response

We agree with the recommendation and, as noted in the report, are currently in the process of establishing a desk audit function.

TAXROLL ADMINISTRATION - SELF-EMPLOYED INDIVIDUALS

When EHT was first introduced in 1990, it was payable by employers only. The tax was extended to self-employed individuals effective January 1, 1993. The Branch relies on individuals who have self-employment income exceeding \$40,000 to register with it voluntarily. We noted that the Branch has no procedures in place to identify self-employed taxpayers who should be registered with the Branch but are not.

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We were informed that another branch within the Ministry periodically receives computer-based information which provides data on incomes of self-employed individuals. We suggested the Ministry utilize this information to compare individuals with self-employed income greater than \$40,000 against the Branch's EHT database. The Ministry completed this matching for the 1994 taxation year. The initial results indicated that, potentially, thousands of unregistered self-employed EHT taxpayers are estimated to owe up to \$7 million in unassessed EHT for that taxation year.

We acknowledge that, as a result of the *1996 Ontario Budget*, the self-employed will be fully exempt from EHT in 1999. However, the Ministry can reassess a taxpayer up to four years after a return has been filed, and it plans to continue auditing self-employed taxpayers until 2003. Accordingly, we believe that this matching will continue to be a cost-effective strategy up to the 1998 taxation year.

Recommendation

To detect unregistered self-employed taxpayers who may be liable for employer health tax and those who have underreported their income, the Ministry should compare the information contained in its employer health tax database against other relevant and available information.

Ministry Response

As stated in the report, the Branch has completed the initial match of the 1994 taxation year and is in the process of contacting taxpayers. It is the Branch's intention to continue with this exercise for other taxation years.

WORKERS' COMPENSATION BOARD/ EMPLOYER HEALTH TAX JOINT REPORT

In late 1995 senior officials from the Ministry of Finance, Workers' Compensation Board (WCB) and the Ministry of Labour formed a steering committee to oversee a joint study carried out by representatives from the Employer Health Tax Branch and the WCB. The goal of the study was to review EHT and WCB revenue-related functions to identify opportunities to achieve cost savings, increase revenues and provide a more efficient level of service. In August 1996 a report was issued to the deputy ministers of Finance and Labour as well as the Chair of the WCB. The report identified 28 opportunities to reduce costs, increase revenue and improve operational efficiencies.

Two significant areas where opportunities for improvements exist are information sharing and the audit process. The report indicated that benefits from the exchange of information could be achieved at moderate cost and with minimal risk. In addition, both organizations could benefit from reduced costs and increased revenues resulting from the exchange of audit results, the development of a combined audit plan and the performance of joint audits.

We were advised that, as of February 1997, the Ministry and WCB were considering the implementation of pilot studies in several areas. This is a noteworthy joint initiative.

RETURNS, PAYMENT PROCESSING AND RECONCILIATION PROCEDURES

During the 1995/96 fiscal year, the Taxation Data Centre processed approximately 396,000 employer returns and 54,000 self-employed returns and about \$2.6 billion in payments. Sixty percent of the tax collected was paid at designated financial institutions and 40% was submitted by mail.

Payments contain a cheque and a remittance form completed by the taxpayer. Payments made at financial institutions are deposited to the Ministry's bank account and the remittance forms and a summary of the deposits are forwarded to the Centre. The Centre deposits cheques from mailed-in payments in the Ministry's bank account. Taxpayer accounts are updated to reflect payments from the remittance forms. Each day the total deposits are reconciled to the total amount of payments input from the remittance forms.

A list of all daily deposits is electronically transmitted to Central Accounts (Public Accounts). In addition a listing of all daily deposits is provided to the Corporate Planning and Financial Branch for updating the ministry general ledger. The Corporate Planning and Financial Branch reconciles the amount recorded in the general ledger with the amount recorded in Central Accounts. Also, the Employer Health Tax Branch reconciles the total amounts posted to the taxpayers' accounts with the total amount recorded in the general ledger.

The Ministry's Audit Services Branch audits the Centre's operations annually to assess the adequacy of its financial controls and to verify the accuracy of taxation revenue reported by the Ministry. In its previous four audit reports, the Audit Services Branch concluded that revenue processing was accurate and management practices and the system of financial controls were effective.

Our review of the Branch's work supported these conclusions. In addition, we selected a sample of tax payments processed since August 1995 and noted that they were generally deposited promptly and accurately recorded in the taxpayers' accounts. We also selected a sample of EHT returns filed in March 1996 and verified that they had been accurately processed.

The Centre is required to reconcile the total payments recorded in the taxpayers' accounts with the total deposits made to the Ministry's bank account on a monthly basis. Also, all refunds paid out are reconciled with the refunds recorded as having been paid. With one exception, the monthly reconciliations were being completed on a timely basis. The one reconciliation that was not up to date at the time we reviewed this area was satisfactorily completed at the conclusion of our audit fieldwork.

OTHER MATTERS

IMPACT OF LEGISLATIVE CHANGES

Currently there are approximately 396,000 public and private sector registered employers. Of these, 82% are small employers who remit EHT annually and 9% are medium-sized employers

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who remit quarterly. The remaining 9% are the largest employers and must make monthly payments. In addition, there are approximately 54,000 self-employed EHT taxpayers.

Legislative changes to the *Employer Health Tax Act* were announced in the *1996 Ontario Budget*. Specifically, by January 1, 1999, private sector employers with annual payrolls under \$400,000 will be exempt from tax, and individuals will no longer be required to pay EHT on self-employment income. These exemptions are being phased in over three years, with all private sector annual filers being exempt as of January 1, 1997, and quarterly filers being fully exempt by 1999, by which time the Ministry estimates that 88% or 270,000 of Ontario's private sector employers will no longer pay EHT. All public sector employers are excluded from the exemption.

The Branch employs approximately 177 staff, with 56 of them working in the audit area and 88 assigned to taxroll administration. In May 1996 the Branch prepared a report that discussed the impact of the expected legislative changes on branch workloads. The report concluded that "the impact on staffing levels (if any) will be minimal" based on the following observations.

- There will be minimal impact on audit staff as audits focus on the larger accounts (annual remuneration over \$400,000) and these larger taxpayers are unaffected by the exemptions.
- Branch resources are devoted primarily to monthly filers as they involve the most frequent contact with the Ministry.
- Smaller taxpayers who file annually, although comprising the bulk of the taxroll, require fewer branch resources because they do not make instalment payments and, therefore, rarely contact the Branch during the year.

We reviewed the report and evaluated the basis for its conclusion that the impact of the legislative changes on the Branch would be minimal and had the following observations.

- Since the Branch focuses audit resources on large monthly filers, we agree there will be no significant impact on the level of audit resources required.
- When taxroll administration managers at the six regional offices were asked what they thought the impact of the changes would be, four managers indicated minimal impact, one manager stated he had not yet assessed the situation and one manager replied that the impact on the taxroll area would be significant.
- The Branch had no documented analysis of the work carried out by the taxroll administrators to determine where they spent their time. According to the taxroll managers, approximately 35% of staff time is spent answering telephone queries from the public and another 40% is spent following up on correspondence from taxpayers.

Accordingly, for 11 days selected at random throughout the year for four regional offices, we analyzed all documents processed by taxroll administrators to determine which employer category they fell into. Of the documents handled, 63% represented annual filers while only 20% represented monthly filers or public sector employees. The balance represented quarterly and self-employed taxpayers.

We also requested that all six regions record the EHT account numbers for all telephone inquiries answered on 15 days we randomly selected between October 1996 and February 1997. Of those inquiries, we noted 56% represented annual filers while 29% represented monthly or public sector employers. The balance represented quarterly and self-employed taxpayers.

Our analysis indicated that the annual filers who will be off the taxroll by 1997 were responsible for well over half the written and telephone inquiries handled by the regional taxroll administrators. This differs significantly from the Branch's conclusion that annual filers use relatively few resources. Accordingly, even after taking into account the resource requirements of the new desk audit function, we believe the impact of the new legislation on the taxroll administration area warrants further study by the Ministry.

Recommendation

The Ministry should closely monitor the potential effects on the workload in the tax administration area of the impending changes to the employer health tax taxroll due to recent changes to the *Employer Health Tax Act*.

Ministry Response

The Ministry agrees that the impact of recent revisions to the Employer Health Tax Act needs to be closely monitored and, as in the past, if the Ministry's analysis indicates that workloads have changed, resources will be reallocated. One example of this was the announcement in the 1996 budget speech that 50 person-years would be reassigned to the Retail Sales Tax Branch's field audit from other programs within the Ministry. Another recent example of this is the planned transfer of 14 staff positions from tax compliance into desk audit in the Employer Health Tax Branch.

REPORTING OF RESULTS

One of the recommendations of the Ontario Financial Review Commission was for each ministry to prepare a three-year business plan and include what it believes to be suitable performance measures and targets. The government supported this recommendation and required ministries to prepare such plans in 1996. The Ministry of Finance finalized its first Business Plan in May 1996.

In June 1997 the Ministry completed its Business Plan for the 1997/98 fiscal year. The Ministry's stated goal for the tax administration area was "to maintain the integrity of the province's self-assessing tax system by encouraging compliance and discouraging non-compliance."

The Ministry is in the process of developing quantifiable performance measures to allow it to measure and report on this goal. One indicator that has been developed is to have an efficient tax system with reduced public administration and taxpayer compliance costs. With regard to measuring and reporting on this indicator, the Ministry needs to consider the work done in 1994 by the United States General Accounting Office when that Office was determining whether a reliable estimate of the cost to business taxpayers of complying with the tax code was possible. Their work indicated that "to separate tax compliance costs from other costs of doing business would be burdensome and of questionable usefulness to [businesses]."

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The reporting of results against stated goals is as important at the branch or program level as it is at the ministry level. The Employer Health Tax Branch's plan has four stated goals:

- to encourage voluntary compliance;
- to provide fair and equitable treatment of taxpayers while ensuring that provincial tax revenues are maintained at optimal levels;
- to identify and resolve issues of non-compliance; and
- to support the review and design of tax policy which will promote the administration of a fair and equitable tax system.

Branch management information reports provide statistics on a number of operational indicators such as dollar amounts of reassessments resulting from audits, number of audits completed, total number of documents administered and the total number of inquiries serviced.

However, these indicators provide only minimal information on the impact the Branch's enforcement and service activities are having on improving voluntary compliance and optimizing tax revenues. We believe that there are other indicators which would, over time, provide information on the relative impact the Branch's activities were having on accomplishing these objectives such as:

- the number of returns not filed by registered EHT taxpayers each year;
- the number of taxpayers who had two consecutive audits resulting in reassessments; and
- the amount of EHT recovered per audit hour.

Recommendation

The Employer Health Tax Branch should develop performance measures which, over time, would provide an indication of the impact its activities are having on encouraging voluntary compliance and optimizing tax revenues.

Ministry Response

The Ministry is in the process of creating a data warehouse that will contain information from the major systems in the Tax Division and external feeds from Revenue Canada. This facility will then allow any Tax Division branch to better monitor performance.