

Retail Sales Tax Program

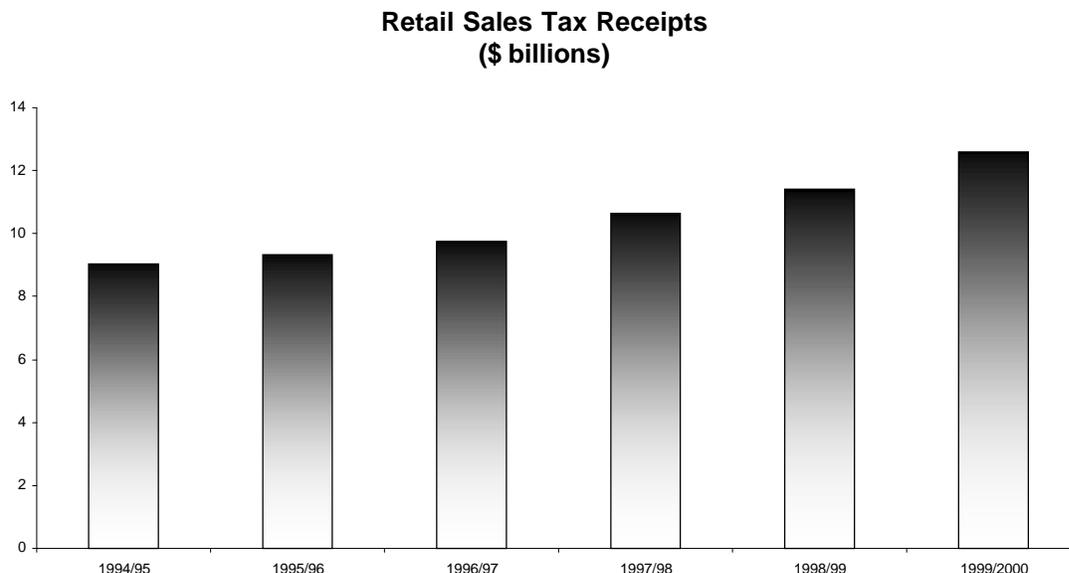
BACKGROUND

Currently, the *Retail Sales Tax Act* imposes a general sales tax of 8% on the retail price of most goods and services sold to final consumers. The Act also levies sales tax at variable rates between 4% (for example, on automobile insurance) and 12% (for example, on alcoholic beverages).

Sixty-three types of tax exemptions cover thousands of items. Many of these exemptions aim to reduce tax regression or have economic or social objectives. Examples of such exemptions include children's clothing, equipment designed for use by people with disabilities and goods purchased by Status Indians under certain conditions.

As at December 31, 1999, approximately 380,000 vendors were registered to collect and remit retail sales tax (RST) to the province (for vendor population by type, see table in section Audit Coverage and Selection). RST receipts for the 1999/2000 fiscal year totalled approximately \$12.6 billion, net of \$159.5 million in refunds, which represented 21% of the province's total revenue.

The chart below shows tax receipts for the last six years.



Source: Ministry of Finance

The Retail Sales Tax Branch, operating through its head office in Oshawa and four regional and seven field offices throughout the province, has primary responsibility for the administration and enforcement of the *Retail Sales Tax Act*. Other ministry branches provide specialized support: the Special Investigations Branch investigates complex cases of tax evasion; the Collections and Compliance Branch collects overdue amounts, follows up overdue returns and identifies non-registered vendors; the Tax Appeals Branch handles all objections and appeals; and the Revenue Operations and Client Services Branch processes all tax returns and related payments.

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AUDIT OBJECTIVE AND SCOPE

Our audit objective was to assess whether the Ministry had adequate procedures in place to ensure that the appropriate amount of RST was collected and remitted to the province on a timely basis, 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 Ministry's head office and three regional offices, the Special Investigations Branch, the Collections and Compliance Branch, the Tax Appeals Branch and the Revenue Operations and Client Services Branch.

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

Our audit work covered the period up to March 31, 2000, with emphasis on the procedures in place with respect to RST revenues processed in the 1999/2000 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.

We reviewed and relied on the work performed annually on the processing of RST returns at the Revenue Operations and Client Services Branch by the Ministry's Audit Services Branch. However, the Branch's work did not affect the other aspects of our audit because the Branch had not conducted work on these aspects of the Retail Sales Tax Program during the last three years.

OVERALL AUDIT CONCLUSIONS

Although RST revenues have gone up significantly and the Ministry has made improvements to its administration of this program since we last audited it in 1995, we concluded that the Ministry needed to further improve its procedures to ensure that:

- All vendors selling taxable goods and services are registered with the Ministry to collect and remit the appropriate amount of tax.

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- Overdue sales tax returns are followed up and received on a timely basis.
 - Collection actions for overdue amounts outstanding are strengthened and performed on a more timely basis.

With respect to the Ministry's enforcement initiatives, we concluded that the Ministry needed to:

- research the nature and extent of the underground economy in order to identify aspects of the economy in need of more rigorous service and enforcement action;
- increase its overall audit coverage to the desired level established by the Ministry; and
- more representatively select vendors for audit with a view not only to maximizing audit revenues but also encouraging broad-based voluntary compliance.

We also noted that adequate controls were in place to ensure that sales tax returns were reviewed for accuracy and were correctly processed on a timely basis.

DETAILED AUDIT OBSERVATIONS

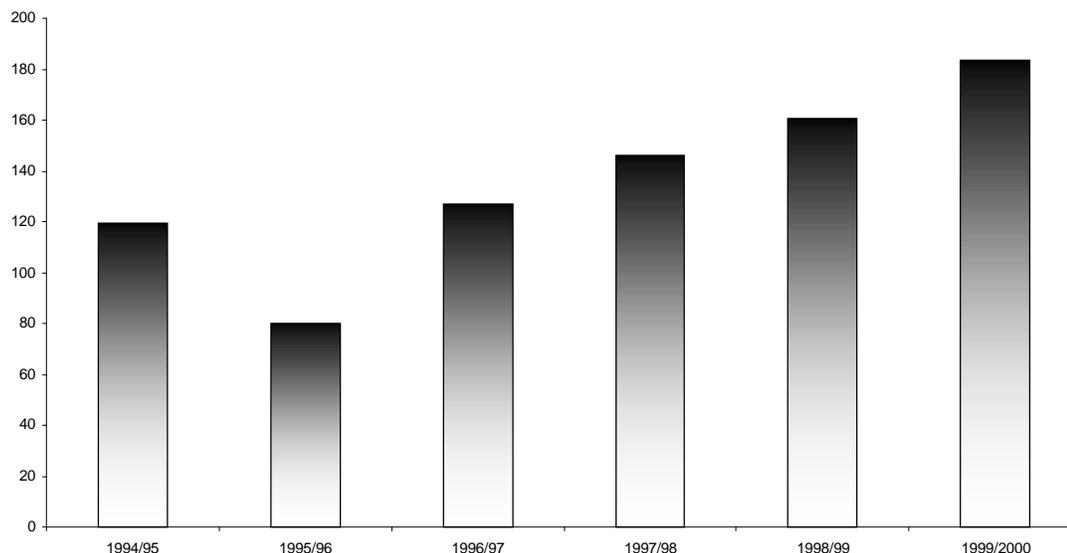
All vendors selling taxable goods and services must be registered with the Ministry and have available their RST permit at their place of business. In addition, they are required to file an RST return and remit the sales tax collected before the 23rd day following the end of their reporting period. Reporting periods vary from monthly to semi-annually depending on the amount of tax collected by a vendor. Sales tax returns and remittances may be mailed directly to the Ministry's Revenue Operations and Client Services Branch, dropped off at any ministry office or paid at most financial institutions in Ontario.

The Ministry's objective is to administer the collection of RST in a way that will encourage broad-based, voluntary compliance, while at the same time enforcing compliance to maintain equity and public confidence in the fairness of the tax system. To achieve this objective, approximately 240 administrative staff work to promote voluntary compliance by providing support services to vendors, such as responding to general inquiries and keeping the tax roll up-to-date. Approximately 560 staff are involved in audit and refund-related activities.

In our 1995 report on the RST Program, we recommended that audit coverage be significantly increased. In 1995, the Ministry employed 152 RST auditors; by 2000, the number of auditors had increased to 418. The chart below illustrates the resulting increase in RST assessments.

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**Retail Sales Tax Assessments by Year
(\$ millions)**



Source: Ministry of Finance

TAX ROLL

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

We reviewed the Ministry's procedures for ensuring that the tax roll was complete and accurate. Our review resulted in the following concerns:

- The Ministry did not have adequate procedures in place to ensure that the Ministry of Consumer and Commercial Relations notified the RST Branch of potential new vendors when new businesses were incorporated or otherwise registered with it. Instead, the Branch relied on new businesses to register voluntarily if they intended to sell taxable goods or services in Ontario.
- The Ministry had no regular procedures for identifying existing non-registered businesses through data matches with other government databases. Although the Ministry had agreed to establish such procedures in response to a recommendation in our 1995 audit report on the RST Program, we were advised that data matching had not been implemented on a large scale due to Y2K priorities and a ministry freeze on changes to the existing computer system.
- Similarly, the Ministry needed to strengthen its procedures for regularly identifying non-registered vendors at their places of business or at points of sale.

Without a complete and accurate tax roll, the Ministry cannot ensure that the correct amount of RST is collected and remitted to the province.

Recommendation

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

- work with the Ministry of Consumer and Commercial Relations to ensure that it is appropriately advised of newly registered businesses for potential inclusion in the tax roll; and
- implement additional procedures needed for identifying non-registered vendors selling taxable goods and services through data matching with other government databases or at their places of business.

Ministry Response

Most businesses register voluntarily with the Retail Sales Tax (RST) Branch. The Ministry is currently taking steps to link data already provided by the Ministry of Consumer and Commercial Relations (MCCR) with the RST database.

The Ministry already has an exchange with MCCR via the Ontario Business Connects (OBC) workstations. If a business registers via OBC, the Ministry is notified and the RST database is updated to record the new vendor.

Although the Ministry has a number of data matching programs already in place, it agrees that it could do more in this area, including further contact with MCCR regarding data matching opportunities.

The Ministry has developed and implemented a process for identifying non-registered vendors by matching RST and GST databases. The Ministry is also developing a new work management system, which is scheduled to be implemented later this year, to assist with the investigation and registration of businesses identified as non-registered through the matching process.

OVERDUE SALES TAX RETURNS

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. As at December 31, 1999, approximately 51,000 vendors had defaulted on filing the required 160,000 sales tax returns.

Depending on the status of the account in default, the Ministry takes a number of progressive follow-up actions (including system-generated reminder notices followed by telephone contact), which in turn depend on the risk of loss. If the default continues, an estimated assessment is to be issued based on previous returns and remittances or remittances from other similar vendors.

We reviewed a number of vendor defaults assigned to regional and head offices for follow-up and found that required follow-up work was not timely for approximately half of the assigned accounts we reviewed. For example:

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- Three to twenty months elapsed after the assignment was made before any follow-up action was taken.
- Three to twelve months elapsed before the second phone call was made or an estimated assessment of taxes owed was issued.

We understand that many of the initial delays were attributable to problems associated with integrating the RST System with the Integrated Collections System (ICS), where a large number of accounts did not get assigned for follow-up action between May 1998 and September 1999.

Prompt follow-up of vendors in default of filing a return is important because, as the time period between defaults and follow-ups increases, the possibility of collecting outstanding remittances diminishes.

Recommendation

To identify and follow up outstanding retail sales tax (RST) returns and required remittances more promptly, the Ministry should ensure that:

- vendors with overdue tax returns are contacted within the required time periods; and
- when necessary, estimated assessments are issued on a more timely basis.

Ministry Response

The Ministry experienced a system problem that resulted in a backlog of RST non-filer accounts being referred for follow-up action. The Ministry identified the system problem in June 1999 and resolved it immediately. The Ministry routinely prepares estimated assessments in failure-to-file situations as part of its telephone follow-up.

The Ministry has recently expanded its resources to ensure more timely follow-up and assessment of outstanding sales tax returns and is also developing a new work management system to assist with the collection of past due returns. This system is scheduled to be implemented later this year.

COLLECTIONS

Accounts receivable result primarily from RST assessments and from vendors submitting RST returns without full payment. By October 31, 1999, RST accounts receivable had increased to \$587 million (before an allowance for doubtful accounts of \$201 million) from \$272 million (before an allowance for doubtful accounts of \$96 million) at the time of our last audit of this program in 1995. We understand that factors that contributed to this increase include a growth in revenue of \$3.5 billion over this period and a significant increase in the amount of assessments resulting from audits.

**Outstanding Retail Sales Tax Accounts by Amount
as of October 31, 1999**

Accounts with Outstanding Balances of:	% of Total Number of Accounts with Outstanding Balances	Total Value (\$ millions)
\$100,000+	2	271
\$25,001 to \$100,000	7	167
\$5,001 to \$25,000	18	111
\$1,000 to \$5,000	24	31
Less than \$1,000	49	7
	100	587

Source: Ministry of Finance

**Outstanding Retail Sales Tax Amounts by Time Overdue
as of October 31, 1999**

Past Due	Dollar Amount (\$ millions)	% Total Dollars
0 - 90 days	89	15
90 days to one year	120	20
One year to two years	100	17
Two years to three years	116	20
More than three years	162	28
Total	587	100

Source: Ministry of Finance

When an account becomes overdue, the Ministry's RST System normally generates two reminder letters. If the account remains outstanding, the Integrated Collection System assigns it to a collector in either the Ministry's head office or a regional office for further follow-up. Within 30 days of the assignment, the collector is expected to send additional collection letters, conduct follow-up telephone calls and consider initiating legal actions, such as bank garnishments and liens.

Large outstanding balances are generally assigned to the individual "work stacks" of senior collectors while smaller balances are assigned to the work stacks of other collectors. In addition, the Integrated Collection System has a number of specific work stacks for accounts identified as high-risk businesses.

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All collectors are expected to address the accounts in their work stacks in descending order of outstanding balance amounts. For example, before working on a particular account, the collector must first work on all the accounts with higher outstanding balances than that one.

We reviewed a sample of accounts receivable files with outstanding balances over \$100,000 and found that the required collection efforts had been taken on these accounts on a timely basis. However, for accounts with outstanding balances less than \$100,000, we found that collection efforts were not timely for approximately 20% of the files we reviewed, many of which were under \$10,000. For example, many of these accounts had not been followed up for periods of up to two years.

Recommendation

To help maximize the collection of all outstanding accounts receivable, the Ministry should ensure that all accounts receive timely action by a collector, including those under \$10,000.

Ministry Response

We agree that all outstanding accounts should receive timely follow-up. The Ministry allocates all its resources on a priority basis to ensure accounts with the greatest risk of loss receive timely action. The majority of outstanding accounts identified by the Provincial Auditor as requiring more timely action were considered by the Ministry to be unlikely to be collected.

The Ministry is currently improving management information processes for monitoring accounts receivable to ensure timely action is taken.

ENFORCEMENT

TAX GAP

The “tax gap” refers to the amount of RST that is due to the province but never gets remitted. The tax gap results primarily from both registered and unregistered vendors that either do not charge tax on taxable sales or that charge tax but do not remit it to the province.

Although the nature and amount of the tax gap is difficult to quantify, it is generally thought to be significant and attributable to the underground economy. Therefore, the Ministry is focusing its resources on identifying the causes of the tax gap rather than on determining the amount.

In our 1995 report, we recommended that the Ministry conduct research into the underground economy and use its results to focus its efforts on reducing the tax gap. In addition, the Standing Committee on Public Accounts, as a result of its hearings, recommended that research and analysis focus on non-compliance in order to ensure enforcement resources are used in the most cost-effective manner.

The Ministry agreed with these recommendations in principle and committed to include the necessary management performance indicators in its planned Integrated Tax Administration

System, which was to have been completed in 1997. However, the completion of that system has been delayed, with the result that research into the underground economy has not been undertaken.

While we acknowledge that identifying and estimating the tax gap is a difficult and imprecise task, there are initiatives that the Ministry could currently undertake to identify segments of the underground economy contributing to the tax gap. These include:

- more emphasis on identifying non-registered vendors and analyzing the extent and impact of non-registered vendors by industry sector; and
- analyzing the dollar value of assessments issued as a result of audits conducted by industry sector and type of vendor, relative to the number of audits completed for a particular sector.

Both of these initiatives would help to identify aspects of the economy in need of more rigorous compliance and enforcement activities aimed at reducing the tax gap.

Recommendation

To help reduce the tax gap, the Ministry should conduct the research necessary to identify significant aspects of the underground economy and focus its compliance and enforcement efforts on these aspects.

Ministry Response

Ontario is taking steps to reduce taxation through tax cuts, which should reduce the tax gap.

The Ministry is in the process of restructuring its identification and compliance functions, which includes forming a Compliance Planning and Research Unit. This unit will have primary responsibility in this area as well as a coordination role with other enforcement functions (especially audit). In addition, the Ministry is working with the Canada Customs and Revenue Agency (CCRA) and other provinces to leverage best practices in the area of compliance research. Ontario is committed to working with all the provinces and CCRA to address the underground economy and has taken a lead role in establishing a National Working Group on the Underground Economy, which had its inaugural meeting in June, 2000.

The Ministry is currently reviewing the Retail Sales Tax Branch's existing business processes and mainframe operating system (BASYS). This review will include investigating opportunities to improve compliance and reduce tax leakage by using intelligent systems to capture more information in order to enhance audit selection and allow for modelling and forecasting impacts of various initiatives.

AUDIT COVERAGE AND SELECTION

AUDIT COVERAGE

The objective of the Ministry's audit efforts is twofold: to determine whether individual vendors selected for audit have remitted the correct amount of tax owed; and to encourage voluntary compliance in the broader vendor community. To meet these objectives it is important that an adequate and representative level of audit coverage is maintained.

Vendors are grouped into one of three categories, as the following table illustrates.

Vendor Population by Type

Vendor Type	Number of Vendors as of December 31, 1999	Annual Revenue	or	Annual Tax Remitted
Large	204	Over \$1 billion	or	Over \$5 million
Medium	11,812	Over \$30 million	or	Over \$100,000
Small	366,961	Under \$30 million	or	Under \$100,000

Source: Ministry of Finance

Although the audit coverage for small vendors has increased significantly since the time of our last audit in 1995, the Ministry has not included all segments of the small vendor population in its audit coverage. In addition, it is necessary that the Ministry review its overall audit coverage of small vendors to ensure visibility in the broader vendor community and thereby encourage broad-based voluntary compliance.

As illustrated in the following table, the recovery rate per audit hour varies by vendor type.

Per-Audit-Hour Recovery Rates by Type of Vendor

Vendor Type	Average Recovery Per Audit Hour for 2000
Large	\$865
Medium	
Small	\$290
Overall Average Recovery per Audit Hour	\$437

Source: Ministry of Finance

We noted that, overall, 70% of all audits resulted in an assessment of taxes owed. In addition, despite the relatively significant increase in the audit coverage of small vendors, where there is a lower tax recovery per audit hour than for larger vendors, the current overall average recovery per audit hour of \$437 is comparable to the average recovery of \$466 per hour in 1995.

Good audit coverage is the cornerstone of tax enforcement. Without it, the Ministry cannot effectively detect whether taxes are being remitted as required, and broad-based voluntary compliance by the vendor community is not encouraged.

Recommendation

To detect unpaid retail sales taxes owed to the province and to encourage broad-based voluntary compliance, the Ministry should include all segments of the small vendor population in its audit coverage and attain overall audit coverage levels that will ensure visibility in the broader vendor community.

Ministry Response

Since 1995, the Ministry has increased its retail sales tax audit coverage of small vendors by 183%. The Ministry will undertake a review of its audit coverage levels of small vendors to determine the impact of broadening it to include all segments of the small vendor population. Any expansion would take into consideration the resource impacts and would be balanced against the Ministry's ability to maintain a large and visible impact of its established audit coverage.

AUDIT SELECTION

To facilitate the process of selecting vendors for audit, like vendors are grouped into one of 150 profile codes. Among other things, these groupings enable the Ministry to compare tax yields of all vendors in a group and generally ensure that some vendors are selected for audit from a broad spectrum of the tax roll.

Our review of audits completed during the 1999/2000 fiscal year by profile codes containing at least 500 vendors indicated that for 43% of them audit coverage was minimal. These codes included what we considered high-risk vendors. In addition, only 13 profile codes were audited to the overall desired level.

Ministry staff advised us that they selected vendors for audit based on their judgment, with an emphasis on potential audit recoveries rather than representative selection. Although this approach meets one part of the Ministry's audit objective, to determine whether individual vendors have remitted the correct amount of tax owed, it provides no assurance that audit coverage is sufficiently representative to encourage voluntary compliance in the broader vendor community.

Our review of the audit selection process also indicated that:

- for a sample of vendor files we reviewed, the assigned profile code did not agree with the vendor's registration form approximately 25% of the time; and
- at one regional tax office, audit managers selected vendors for potential audit by placing them in their personal audit banks, which prevented other auditors from auditing them. Approximately one-third of these vendors had been in audit banks for over one year, with an average time of 2.5 years, without any audit work being performed.

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In addition, at two of the three regional tax offices we visited, some audits had been in progress for an extended period of time, averaging about 1.7 years. Ministry staff were unable to provide reasonable explanations for the delays in about one quarter of these instances.

If audit selection does not sufficiently reflect the full spectrum of vendors or if audits are not performed in a timely manner, vendor confidence in the fairness and effectiveness of the RST Program may weaken which, over time, could result in lower levels of compliance.

Recommendation

To help ensure that it meets its objectives for encouraging voluntary vendor compliance as well as for recovery of retail sales taxes owing, the Ministry should:

- **select vendor files for audit on a more representative basis, with a view to encouraging broad-based, voluntary compliance; and**
- **ensure that selected audits commence and are completed on a timely basis.**

Ministry Response

Experience has demonstrated that certain profile codes represent greater compliance risk than others. To ensure the effective utilization of audit resources and enhance compliance, the Ministry employs a risk-based approach to audit selection. The Ministry intends to enhance its audit selection process using external data sources to detect non-compliance. Any expansion to other areas would have to take into consideration the resource implications and be balanced against the Retail Sales Tax Branch's ability to maintain a large and visible impact in the sectors now selected.

We agree that audits should commence and be completed on a timely basis. Existing processes will be changed, where necessary, and audits will be reviewed by quality assurance staff on a periodic basis to ensure audits are assigned and completed on a timely basis.

MANAGEMENT INFORMATION SYSTEM

The RST Branch uses a computerized information system, BASYS, to assist with the selection of audits. At the time of our previous audit of the RST Program in 1995, the Ministry was planning to replace BASYS with a new integrated computer system by 1997. In our 1995 audit, we identified some information that BASYS did not produce which would be useful in selecting high-risk vendors for audit and recommended that the Ministry ensure that this information be considered in the development of its new system. Similarly, the Standing Committee on Public Accounts recommended that the new computer system incorporate clearly defined information needs, related analysis and implementation deadlines.

However, at the conclusion of our current audit, the Ministry had not replaced BASYS but was in the process of developing a business case to rationalize the need for re-engineering the

business processes in the Branch, including BASYS. We will be following up on these re-engineering initiatives at an appropriate time in the future to see whether the concerns we expressed in our 1995 audit, and in this audit, are adequately addressed.

TAX REFUNDS

Sales tax that has been paid may be refunded under certain conditions, for example, if the tax was paid in error or if a visitor to Ontario has paid tax of \$50 or more on goods purchased for use or consumption outside the province. During the 1999/2000 fiscal year, the Ministry processed approximately 37,500 refund claims having a total value of \$130 million. Requests for refunds under \$100,000 are processed at the Ministry's head office and requests for refunds over \$100,000 are processed at regional tax offices.

We reviewed a sample of refunds issued and found that they were accurately processed and properly approved. However, we also noted that, in some cases refunds issued to registered vendors were issued "subject to audit" when, for example, eligibility for a refund had not been conclusively established. A list of refunds issued subject to audit is to be maintained and distributed to regional tax offices for follow-up.

We found that such a list was neither maintained nor distributed to regional tax offices as required. As a result, the Ministry did not know how many refunds were issued subject to audit or whether any of them had been followed up and audited.

Recommendation

To help ensure that only eligible refunds of retail sales tax are made, the Ministry should maintain a list of refunds issued subject to audit and ensure that, where refunds are issued subject to audit, the necessary follow-up work is performed.

Ministry Response

All vendors receiving refunds subject to audit would have been considered for audit under the Retail Sales Tax Branch's normal audit selection process. The Ministry will take steps to ensure the listings are prepared on a regular basis and distributed to the appropriate offices for consideration in future audit selection.

PENALTIES

The *Retail Sales Tax Act* provides for the imposition of a 25% penalty when the correct amount of tax is not remitted due to neglect, carelessness, willful default or fraud on the part of the taxpayer. Ministry policy requires that this penalty be imposed where the amount of tax assessed exceeds a set amount, except in cases where not imposing the penalty is supported by clearly documented reasons.

For the 1998/99 fiscal year, the total amount of penalties imposed was \$6 million. We reviewed a sample of audit files and found that, for our sample, penalties had not been imposed for 40%

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of the instances where the assessed tax exceeded the set amount. The reasons for failing to impose the required penalties were not documented.

These penalties are expected to deter vendors from failing to remit the amount of RST owing. However, if penalties are not imposed as required, their value as a deterrent will be impaired.

Recommendation

To provide an effective deterrent, the Ministry should consider imposing the legislated 25% penalty in cases where correct retail sales tax amounts are not remitted as a result of taxpayer neglect, carelessness, willful default or fraud. When a penalty is not imposed, the Ministry should ensure that the reasons are clearly documented.

In addition, the Ministry should review and determine whether the threshold amount below which penalties are not assessed is appropriate.

Ministry Response

We agree that auditors should impose the 25% penalty where applicable or document their rationale for not doing so in accordance with the Retail Sales Tax Branch's existing policy. All offices have been instructed to adhere to the policy, and audits will be reviewed by quality assurance staff on a periodic basis for adherence to the policy.

The Ministry agrees to undertake a review of the current penalty threshold.

REVENUE AND RETURNS PROCESSING

During fiscal 1998/99, approximately 3 million returns were submitted to the Ministry's Taxation Data Centre (TDC) in Oshawa for processing. The Ministry's Audit Services Branch audits TDC operations annually. In their most recent audit report, the Branch concluded that the Ministry's revenue processing was accurate, management practices were effective and the system of financial controls for revenue processing continued to ensure timely and accurate revenue recording.

We conducted a walk-through of the returns processing system at TDC and noted that adequate controls were in place to ensure returns were reviewed for accuracy and were correctly processed. In addition, there was no evidence of a backlog in returns processing.