

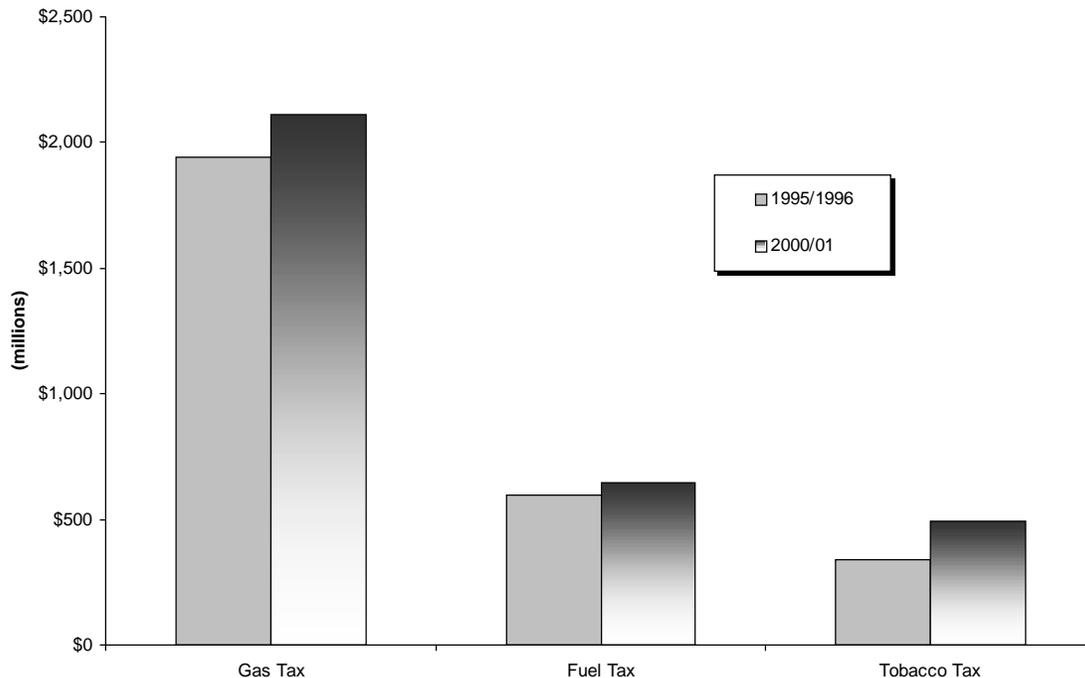
3.08—Gasoline, Fuel, and Tobacco Taxes

BACKGROUND

In Ontario, commodity taxes on gasoline, fuel, and tobacco products are levied under the authority of the *Gasoline Tax Act*, the *Fuel Tax Act*, and the *Tobacco Tax Act*, respectively.

For the 2000/01 fiscal year, the amount of taxes collected under these three acts totalled \$3.25 billion, an increase of 17% over 1995, the year of our last audit. That amount represents approximately 6.7% of the province's total taxation revenue from all sources for the 2000/01 fiscal year.

Tax Revenue by Type, 1995/96 and 2000/01



Source of data: Ministry of Finance

The Ministry's administrative policies and procedures are intended to capture information on the total amounts of gasoline, fuel, and tobacco products manufactured in, imported into, and exported from Ontario. The purpose of this information is to determine both the amount of taxable consumption of those commodities in Ontario and whether the correct amounts of taxes are being declared and paid.

The Ministry of Finance has designated manufacturers and certain large wholesalers of gas, fuel, and tobacco products as collectors and remitters of tax for their respective commodities. As a result, over 95% of these taxes are collected and remitted by approximately 100 companies (referred to subsequently as collectors). Sales and purchases between collectors are tax exempt, while sales by collectors to non-collectors, such as retailers, are taxed.

The Ministry's Motor Fuels and Tobacco Tax Branch (Branch) has primary responsibility for the administration of the three tax acts. The Branch employs approximately 60 staff whose responsibilities include processing tax returns and requests for refunds as well as conducting periodic field audits and inspections designed to ensure that the correct amount of tax has been declared and paid and, in so doing, to deter non-compliance. Other ministry branches provide specialized support: the Special Investigations Branch investigates complex cases of tax evasion; the Collections and Compliance Branch collects overdue amounts; the Tax Appeals Branch handles all objections and appeals; and the Revenue Operations and Client Services Branch processes most payments.

With the exception of the inspection function, which requires staff to work in their assigned geographic areas, all Branch operations are located at the Ministry's head office in Oshawa.

AUDIT OBJECTIVES AND SCOPE

The objectives of our audit of the Ministry's administration of the *Gasoline Tax Act*, the *Fuel Tax Act*, and the *Tobacco Tax Act* were to assess whether the Ministry had:

- adequate policies and procedures in place to ensure that the correct amounts of gasoline, fuel, and tobacco tax were remitted in accordance with statutory requirements; and
- determined the effectiveness of its policies and procedures for the reporting and remitting of these taxes to identify any areas in need of more rigorous efforts to encourage compliance or better enforcement.

The scope of our audit work included a review and analysis of relevant ministry files and administrative procedures as well as interviews with branch staff and with staff at the Special Investigations Branch, the Collections and Compliance Branch, and the Tax Appeals Branch. We also visited two of the busier Canada–United States border crossings to observe customs procedures and interview Canada Customs and Revenue Agency officials and met with representatives of the Canadian Petroleum Products Institute to gain insight into the taxation issues facing the petroleum products industry.

Our audit work covered the period up to March 31, 2001, with emphasis on the policies and procedures in place with respect to gasoline, diesel fuel, and tobacco tax revenues processed in the 2000/01 fiscal year. Although the *Gasoline Tax* and *Fuel Tax* acts also mandate the taxation of propane, aviation fuel, and diesel fuel used by railroads, our audit did not cover those areas because they accounted for only a small part of the total tax revenue and corresponding administrative activity.

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. Prior to the commencement of our work, we

identified the audit criteria that would be used to address our audit objectives. These criteria were reviewed and agreed to by senior ministry management.

We reviewed and relied on the work performed by the Ministry's Internal Audit Services on the processing of tax receipts by the Revenue Operations and Client Services Branch. However, the work of the Audit Services branch did not affect the other aspects of our work because it had not conducted work in those areas during the past three years.

OVERALL AUDIT CONCLUSIONS

The Ministry's policies, procedures, and supporting information technology systems were inadequate for ensuring that all gasoline, fuel, and tobacco taxes were being declared and paid in accordance with statutory requirements.

For example, based on our limited testing of motor fuel and gasoline tax returns, we found up to \$51 million in potential tax revenue losses to the province since the Ministry could not demonstrate that 345 million litres of gasoline and fuel were eventually captured in the tax system or were not sold for a taxable purpose. To overcome these tax collection deficiencies, the Ministry needed to focus on:

- obtaining information on amounts of gasoline and diesel fuel produced in Ontario and reconciling those amounts to reported sales to ensure that tax is paid on all gasoline and diesel production except for legitimate tax-exempt sales;
- regularly comparing the billions of dollars of reported tax-exempt sales and purchases between collectors to ensure that large discrepancies are adequately resolved or assessed for tax; and
- verifying the completeness and accuracy of reported imports and exports by comparing them to independent information such as that provided by inter-jurisdictional transporters of gasoline and diesel fuel, including pipelines.

To make the collection of tobacco taxes more effective, the Ministry needed to:

- obtain and compare information on the quantity of cigarettes produced in Ontario to the quantity of reported sales to ensure that tax is paid on all cigarette production except for legitimate tax-exempt sales;
- implement a more effective system for marking tax-paid cigarettes;
- verify the completeness and accuracy of reported tobacco imports and exports with independent information such as that provided by inter-jurisdictional transporters of tobacco products;
- ensure that the tax on tobacco imports by unregistered importers is declared and paid; and
- consider the need for developing an allocation system for the sale of tax-exempt cigars on native reserves similar to the one in place for cigarettes.

In addition, the Branch needed to significantly strengthen its audit and inspection functions to help ensure that undeclared taxes are identified and assessed.

We also concluded that the Ministry needed to develop, implement, and monitor performance indicators to assess the extent to which it is meeting its objectives of encouraging voluntary compliance and deterring tax evasion.

It is our view that the improvements needed to ensure that all applicable gasoline, fuel, and tobacco taxes are collected will require a significant development of information technology support. Without such support, the complexity and sheer volume of the activities required to collect taxes will make it unlikely that the Ministry will be able to cost-effectively identify potential, undeclared taxes.

Overall Ministry Response

Changes are needed in ministry policies and procedures and especially in supporting information technology in order to attain the goal of total accountability for all gasoline, fuel, and tobacco products at all stages of the production and distribution process.

The audit report raises valid issues, many of which the Ministry was already in the process of addressing or had recognized as areas in which to take action. It is our intent to address any required changes, as detailed in the report, in a manner that balances priorities in terms of risk against the resources available.

DETAILED AUDIT OBSERVATIONS

GASOLINE AND DIESEL FUEL TAXES

Gasoline and fuel used for transportation purposes are currently taxed as outlined in the following table.

Petroleum Product Taxation, 2000/01

Product	Tax Cents Per Litre	Revenue (\$ millions)
gasoline – leaded	17.7	2,045
gasoline – unleaded	14.7	
diesel fuel	14.3	613
diesel fuel – used by railroads	4.5	30
propane fuel	4.3	10
aviation fuel	2.7	56

Source of data: Ministry of Finance

For the 2000/01 fiscal year, the Ministry collected over \$2 billion in gasoline tax and \$643 million in diesel fuel tax. Approximately 98% of the gasoline tax and 94% of the diesel fuel tax were remitted by 18 gasoline tax and 13 diesel fuel tax collectors, respectively.

Diesel fuel that is used in heating, in off-road vehicles, and in machinery such as that used in manufacturing, farming, and construction is not taxed. To distinguish taxable from tax-exempt diesel fuel, tax-exempt fuel is dyed at the refinery or at bulk storage facilities while taxable fuel is left clear.

Refiners and wholesalers that, in the previous year, sold not less than 51% of their product by volume at wholesale are designated as tax collectors by the Ministry. Tax is imposed whenever a designated collector sells a taxable product to a non-collector or a registered importer that is not a collector imports taxable products. Sales between collectors and sales for export are tax exempt. Collectors, and importers that are not collectors, are required to file monthly tax returns along with payment of the correct amount of tax.

In addition, exporters and inter-jurisdictional transporters of petroleum products must be registered with the Branch. Although they are not required to remit taxes, they are required to file monthly returns detailing their movement of petroleum products. This information is to be used to help determine whether all products available for taxable consumption are accounted for.

Casual importers are not registered with the Branch and are required to remit the appropriate provincial tax to the Canada Customs and Revenue Agency at the time they import a taxable product. The Canada Customs and Revenue Agency then forwards the tax to the Ministry.

Gasoline and Diesel Fuel Production

Four refiners operating five refineries account for all the petroleum products produced in Ontario. Each of these refiners is also a designated collector and as such is required to file the applicable gasoline and diesel fuel tax returns, which detail tax-exempt sales to and purchases from other collectors, imports, exports, and taxable sales to non-collectors.

However, we noted that the Ministry did not require the refiners to report the amount of gasoline and diesel fuel they actually produced. As a result, the Ministry cannot assess whether all gasoline and diesel fuel that is produced is reported as sold or otherwise accounted for and that the correct amount of tax is ultimately declared and received.

This information should be readily available as we understand that refiners maintain detailed records of gasoline and diesel fuel produced and that they already provide that information in summary form to Statistics Canada.

Recommendation

To help ensure that all gasoline and diesel fuel produced in Ontario is accounted for as either taxable or tax-exempt sales, the Ministry should require refiners to submit information on gasoline and diesel fuel produced, compare it to reported taxable and tax-exempt sales, and periodically verify the accuracy of the production information received.

Ministry Response

The Ministry had reviewed in the past the legal implications of requiring that refiners submit detailed information on gasoline and diesel production. We will revisit this review.

In the meantime, the feasibility of obtaining available information on production volumes to gain further assurance of the accuracy of reported sales will be further investigated. In that regard, the Ministry will consult with Statistics Canada and Canada Customs and Revenue Agency Excise officials. The results of these inquiries will be used to determine whether production information can be obtained to compare with, and verify, sales figures.

Redesigned return forms for collectors, under the Ministry's re-engineering initiative, will provide additional inventory information to assist in verification of reported taxable and tax-exempt sales.

Gasoline and Diesel Fuel Tax Return Processing

Collectors file gasoline and fuel tax returns using a prescribed format that includes supporting schedules detailing tax-exempt sales to and purchases from other collectors, imports and exports, and the total amount of taxable and other tax-exempt sales.

Although the Branch has initiated steps to establish a desk audit function (that is, a function that would analyze and perform a detailed verification of the information reported in the tax returns), it did not have a desk audit function in place during the period of our audit. Therefore, to help compensate for that lack, we would have expected the tax return review process to be as comprehensive as possible and to include such controls as agreeing reported tax-exempt purchases and sales between collectors and verifying reported imports and exports with the independent information submitted by inter-jurisdictional transporters.

Our review of the Branch's tax return processing function and a sample of tax returns indicated that such comparisons had not been made and that compensatory procedures had not been carried out. Branch staff only conducted a cursory review of the returns, which consisted essentially of ensuring that the required supporting schedules are attached and that they are arithmetically correct and agree in total to the information in the tax return. As a result, branch staff could not determine whether the correct amount of tax had been declared and remitted or identify areas requiring further review. Our specific concerns are detailed below.

TAX-EXEMPT SALES AND PURCHASES BETWEEN COLLECTORS

To ensure that all reported tax-exempt sales between collectors are valid and should not have been taxed, it is imperative that tax-exempt sales reported by one collector are agreed to the tax-exempt purchases reported by the purchasing collector.

We noted that while the Ministry did not normally undertake such comparisons, it did do so for the tax-exempt sales reported by one large collector from August 1995 to April 1999. Although this comparison identified a number of significant variances, none of them had been followed up or had resulted in additional tax assessed.

We reviewed a sample of tax-exempt sales reported by five major collectors during a consecutive 10-month period in the 1999/2000 fiscal year and noted that:

- Collectively, the tax-exempt sales reported by these collectors exceeded the tax-exempt purchases reported by the purchasing collectors by more than 160 million litres. This represents a potential tax loss of almost \$24 million if the unaccounted-for litres were sold for taxable consumption but not reported as such.
- A number of reported tax-exempt sales to other collectors totalling approximately 74 million litres were in fact sales to non-collectors and as such should have been taxed. This represents a potential tax loss of about \$11 million since the Ministry could not demonstrate that the litres involved eventually got captured in the tax system or were not sold for taxable purposes.

Although we expressed similar concerns in our 1995 report, this situation had not yet been satisfactorily addressed by the Branch.

We also noted that collectors frequently entered into various complex swap agreements, whereby they traded petroleum products on an in-kind basis and did not report the trades as sales. Because what constitutes a sale was not clearly communicated, it was unclear whether or not any of these trades should have been declared as sales.

Recommendation

To help ensure that the correct amounts of gasoline and diesel fuel taxes are declared and paid, the Ministry should:

- **verify the accuracy of reported tax-exempt sales and purchases between collectors and ensure that large discrepancies are identified, followed up, and assessed where warranted; and**
- **clearly communicate what constitutes a sale.**

Ministry Response

Although the Ministry is of the view that most large discrepancies are attributable to complex product “swap” arrangements that result in no loss of tax, there is a need to obtain additional information and reconcile this type of product movement. The Ministry will investigate and, where appropriate, propose additional reporting and reconciliation requirements.

A tax bulletin will be issued to ensure that the definition of sale is clearly understood.

GASOLINE AND DIESEL FUEL IMPORTS AND EXPORTS

Inter-jurisdictional transporters are required to file monthly returns with the Branch detailing the source, destination, volume of gasoline or diesel fuel transported, and particulars of the importer/exporter. In addition, in the case of exports to the United States, the exporters' returns must include U.S. customs documentation, bills of lading, and export invoices to support the

tax-exempt exports reported on the return. We would have expected this information to be used to confirm the accuracy of reported imports and tax-exempt exports to determine whether all gasoline and diesel fuel had been accounted for and whether the correct amount of taxes had been declared and paid.

As we noted in our 1995 Annual Report, and again in our current audit, the Branch could not verify the accuracy of reported imports and tax-exempt exports with information provided by the inter-jurisdictional transporters, since in most cases the transporter had not been identified in the import/export returns. In addition, we found that, in most cases, the Branch had not received the required customs documentation, bills of lading, and export invoices for products exported to the United States.

We reviewed the returns from a large exporter covering a consecutive 10-month period and found that the exporter had reported 111 million litres more in tax-exempt exports than could be substantiated by the available transporters' returns. The risk is that the product was actually sold in Ontario for taxable purposes and the tax was never remitted to the Ministry. If this occurred, the tax loss could be as high as \$16.3 million.

We also noted that the most recent list of registered importers available at the two border crossings we visited in late 2000 was dated August 1989. Our review of this list indicated that over 60% of the importers listed were no longer registered with the Ministry. Only registered importers are permitted to import gasoline or diesel fuel without paying the applicable tax at the time of import. An out-of-date list creates a risk that importers that are on the list but no longer registered could bring petroleum products into Ontario, sell them, and collect the tax but never remit it to the Ministry.

Inter-jurisdictional Pipeline Transporters

Although the precise amount is not known, a significant proportion of refined petroleum products are transported into and out of Ontario through pipelines. Since the introduction of the current *Gasoline Tax Act* and *Fuel Tax Act* on January 1, 1992, pipeline companies transporting gasoline or fuel into or out of Ontario have been required to register as inter-jurisdictional transporters and, as such, to comply with the reporting requirements.

However, even though the Ministry knew that at least two pipelines transported taxable products into and out of Ontario, no pipelines had been registered as inter-jurisdictional carriers at the start of the 2000/01 fiscal year. We also noted that:

- Although one of the two known pipelines was eventually registered as an inter-jurisdictional carrier during the 2000/01 fiscal year, it had yet to file a return, in large part because the Ministry had not yet developed the appropriate forms.

In addition, a ministry audit of this pipeline company found that it transported approximately 3.3 billion litres of potentially taxable gasoline and fuel into and out of Ontario during 1999, some of it potentially on its own account, and, therefore, should also have been registered as an importer and exporter but was not.

- The second pipeline had not yet been registered.

Recommendation

To help ensure that all imports and exports of gasoline and diesel fuel are accounted for and that the correct amount of tax is declared and paid, the Ministry should:

- ensure that all gasoline and diesel fuel tax collectors and inter-jurisdictional transporters, including pipelines, submit the information required of them by law;
- verify the accuracy of reported imports and exports by comparing them to information provided by inter-jurisdictional transporters—when significant variances are identified, they should be investigated and resolved on a timely basis;
- provide the Canada Customs and Revenue Agency with an up-to-date list of registered importers to ensure that unregistered importers pay the applicable tax at the time of import; and
- develop the appropriate tax return forms for inter-jurisdictional pipeline transporters.

Ministry Response

The Ministry will review record-keeping procedures and reporting requirements for collectors with respect to imports and exports. Reporting requirements have been reinforced with inter-jurisdictional transporters and they will be more closely monitored and cross-checked against collectors' reports. However, consideration will be given to facilitating or enhancing reporting requirements for the industry, for example, by introducing electronic processes.

Prior to this audit, the Ministry was working with the Canada Customs and Revenue Agency. As a result of this work, the Ministry will soon be providing the Canada Customs and Revenue Agency with updated lists of registered importers, in electronic format and on a regular basis.

Appropriate tax return forms will be developed for pipeline transporters.

Gasoline Tax Refunds

Under provisions of the *Gasoline Tax Act*, natives who hold a valid provincial Certificate of Exemption are entitled to purchase gasoline tax-exempt on a native reserve for their personal use.

For these tax-exempt sales, the retailer must complete a voucher indicating the date of sale, the purchaser's name and vehicle licence number, the number of litres sold, and total sales proceeds net of tax. The voucher must also be signed by the purchaser and include an imprint of the Certificate of Exemption.

Since in most cases the retailer has already paid the gasoline tax with the purchase of gasoline inventory, the retailer can recover the amount of the tax paid in one of two ways:

- by submitting a request for a refund together with the supporting exemption vouchers directly to the Ministry; or
- if the retailer's bulk supplier is a collector, by providing the exemption vouchers to that collector for credit. The collector in turn submits the vouchers to the Ministry and deducts the amount of tax previously paid on the next return.

Although the Ministry did not maintain information with respect to the total amount of gasoline tax refunds issued, based on our review of a sample of these refunds, we estimated that the Ministry had refunded about \$18 million during the 1999/2000 fiscal year. Approximately half of that amount was claimed directly from the Ministry and half was claimed through collector returns.

Regardless of how a refund is requested, all refund claims must be reviewed by the Branch for completeness and accuracy as well as for high volume or otherwise unusual purchases. When considered necessary, the Ministry is to contact the retailer or purchaser to obtain additional information needed to verify the tax-exempt status of the purchases.

We reviewed a sample of refund claims submitted directly to the Ministry and a sample of claims submitted through collectors' returns. We found that the Ministry's review of the refund claims made directly to it by retailers was generally satisfactory and in many cases included adjustments to ensure the appropriateness of the refunded amount.

However, we found no evidence that the Ministry had reviewed the refund claims submitted through collector returns. Our review of such claims indicated a number of questionable items, for example:

- Over a two-day period, one individual claimed tax exemptions for 18 separate purchases from one retailer totalling 690 litres for one vehicle.
- Over another two-day period, another individual claimed tax exemptions for 18 separate purchases from the same retailer totalling 677 litres for one vehicle.
- In many cases, submitted refund vouchers lacked required information, such as the vehicle licence number or the imprint of the Certificate of Exemption, and therefore should have been followed up or disallowed.

Recommendation

To ensure that only eligible gasoline sales are exempted from tax, the Ministry should review refund vouchers submitted by collectors for completeness and reasonableness of exemptions claimed based on assessed risks and follow up on questionable or incomplete vouchers to determine whether or not the purchases qualify as tax-exempt.

Ministry Response

During the audit's sample period, resources had been directed away from this specific activity and assigned to training, documenting, and testing activities

related to a major systems implementation. The process of reviewing retailer claims submitted through collector returns was re-initiated in June 2001 and will be continued on a regular and ongoing basis. As part of the normal vetting process, questionable or incomplete vouchers will be followed up. Where significant or recurring non-compliance is noted, the retailer's permission to route claims through the collector will be withdrawn.

Fuel Acquisition Permits

Under provisions of the *Fuel Tax Act*, certain consumers may apply for a Fuel Acquisition Permit that allows them to purchase tax-exempt, clear diesel fuel for specific purposes such as tobacco curing, kerosene repackaging, and fueling machinery used in manufacturing processes. Permit holders are required to file an annual return with the Branch specifying the amount of tax-exempt fuel purchased and the purposes for which it was used. For the 1999/2000 fiscal year, there were approximately 370 Fuel Acquisition Permit holders.

Based on our discussions with branch staff and our review of a sample of permit holder returns filed during the past three years, we found that the Branch:

- did not maintain information or otherwise track the reasonableness of tax-exempt diesel fuel purchases either as they were reported by individual permit holders or in total;
- did not conduct periodic audits or inspections of all types of permit holder facilities to ensure that tax-exempt fuel purchases were used only for the purposes intended; and
- automatically renewed permits each year for tobacco curers, regardless of whether or not tax-exempt fuel purchases were reported for the previous year. For example, we found in our review of a sample of tobacco curer permit returns for the 1998/99 fiscal year that half of them indicated that natural gas was being used rather than diesel fuel. Nevertheless, those permits were automatically renewed for the following year.

Recommendation

To ensure that tax-exempt diesel fuel purchased by holders of Fuel Acquisition Permits is used only for eligible purposes, the Ministry should:

- **monitor and assess the reasonableness of the tax-exempt diesel fuel purchases reported by Fuel Acquisition Permit holders; and**
- **conduct periodic audits or inspections of all types of permit holder facilities, based on the assessed risks.**

Ministry Response

In addition to work already undertaken, the Ministry will consider additional methods to track tax-exempt product acquisitions, assess permit holder risk vis-à-vis other enforcement priorities, and assess the necessity of certain tobacco curers retaining their permits.

TOBACCO TAXES

Cigarettes and cut tobacco are taxed at 2.65 cents per cigarette and 2.65 cents per gram of cut tobacco, and cigars are taxed at 45% of the price at retail. For the 2000/01 fiscal year, tobacco tax receipts totalled \$493 million, approximately 98% of which was remitted by 71 collectors.

Any wholesaler of tobacco products that applies to the Ministry may be designated a tobacco tax collector. Collectors are required to file monthly tax returns and remit taxes under one of the two methods described below.

- Under the purchase method, collectors must file tax returns on the 28th day of each month for the previous month and remit 90% of the taxes owing on tobacco products purchased from any of the three domestic manufacturers during the previous month. The remaining 10% of tax is to be remitted the following month. All subsequent sales are tax in (that is, they include the tax).
- Under the sales method, collectors file monthly tax returns on the 10th day of each month for the previous month, but remit tax based on sales to non-collectors in the previous month.

At the time of our audit, the Ministry estimated that approximately 70% of tobacco tax was remitted under the purchase method and 30% was remitted under the sales method.

Tobacco-product manufacturers and importers are required to submit monthly sales reports, often referred to as tax memos, which detail sales to collectors. As well, inter-jurisdictional transporters file monthly returns indicating the source, destination, quantity, and ownership of tobacco products transported into and out of Ontario.

Tobacco Tax Return Processing

Our review of the Ministry's tobacco tax return processing procedures and a sample of tobacco tax returns indicated that the Ministry was processing returns satisfactorily. Sales to individual collectors, as reported by manufacturers and importers on tax memos submitted to the Ministry, were reconciled to collector tax returns to ensure that the correct amount of tax had been declared and paid under either the purchase or sales method of remitting tobacco tax.

However, as the following sections demonstrate, the Ministry needed to enhance its existing procedures to ensure that all manufactured, imported, and exported tobacco products are accounted for and that it ultimately receives all of the tax that is due.

CIGARETTE PRODUCTION AND CONTROL

There are three large cigarette manufacturers operating in Ontario. Cigarettes that are manufactured for taxable consumption in Ontario are marked with a yellow tear-tape in the wrap of each package. Cigarettes manufactured for tax-free export or tax-exempt consumption on native reserves are marked with a tear-tape coloured other than yellow.

To help ensure that all cigarettes manufactured for consumption in Ontario can be accounted for, the prescribed monthly tax return completed by cigarette manufacturers includes a schedule requesting information about the number of Ontario-marked cigarettes produced, shipped, and on hand at the end of each month. There are no similar requirements for cigarettes not marked for consumption in Ontario.

In addition, while the monthly tax return also includes a schedule for importers to account for the tax-paid stamps applied to imported cigarettes, there is no requirement for domestic manufacturers to account for the yellow tear-tape material acquired and used to mark Ontario tax-paid cigarettes.

We reviewed a sample of monthly tax returns for the three large domestic cigarette manufacturers and found that one of them had not completed the required schedules. As a result, the Ministry could not determine whether or not all cigarettes manufactured by that manufacturer for taxable consumption in Ontario had been reported as taxable sales or had otherwise been accounted for.

We also noted that:

- by not holding cigarette manufacturers accountable for all cigarettes manufactured, shipped, and on hand at the end of each month, it had no assurance that cigarettes manufactured and marked for consumption outside Ontario were not diverted for untaxed consumption in Ontario; and
- by not holding cigarette manufacturers accountable for the yellow tear-tape material acquired and used, the Ministry had no assurance that it was applied only to cigarettes that had been reported as Ontario-taxable sales.

In 1998, a Canada-wide Tobacco Marking Steering Committee with membership from all 10 provinces and the Canada Customs and Revenue Agency was formed to review the system for marking tobacco products and to propose a more effective one to decrease tax evasion and smuggling. We understand that the proposed system will in all likelihood require the registration and licensing of tear-tape manufacturers. Such licensed manufacturers will be required to sell tear-tape only to licensed cigarette manufacturers, with penalties and sanctions for non-compliance.

Recommendation

The Ministry should ensure that all cigarette manufacturers:

- **submit the required schedules indicating the number of Ontario-marked cigarettes produced, shipped, and on hand; and**
- **provide information about the amount of yellow tear-tape acquired and used.**

The Ministry should then use that information to assess the reasonableness of reported taxable sales.

Ministry Response

The Ministry will require additional inventory information from manufacturers on tax returns that have been redesigned under the re-engineering initiative to assist in determining the reasonableness of reported taxable sales. The requirement to report Ontario-marked production on monthly returns will be reinforced with the manufacturers.

As noted, the issue of tear-tape use and registration of tape manufacturers is under review by an inter-jurisdictional tobacco marking committee, chaired by Ontario.

TOBACCO IMPORTS AND EXPORTS

As was the case for petroleum product imports and exports, inter-jurisdictional tobacco transporters are required to file monthly returns disclosing the source, destination, amount, and ownership of tobacco products transported. Where importers or exporters transport their own products, they must also provide the particulars of such movements with their monthly returns. This information is then to be used by the Branch to verify the completeness and accuracy of reported tobacco-product imports and exports and, ultimately, to ensure that the correct amount of tax has been declared and paid.

However, we found that inter-jurisdictional transporters of tobacco products were not providing the required information, with the result that the Branch could not verify the completeness or accuracy of reported imports and exports. In addition, the Branch did not corroborate reported imports and exports through other means, for example, by checking imports and exports against customs declarations.

Unregistered Importers

In contrast to petroleum product importers, unregistered tobacco product importers are allowed to bring products into Ontario from the United States without paying the applicable provincial tax at the border, even though federal taxes are paid there. Instead of collecting the provincial tax on imports into Ontario, the Canada Customs and Revenue Agency officers prepare a list of imports by unregistered importers that includes such information as the importer's name and address, the date, and the amounts of products imported.

However, we found that the Ministry did not routinely request this list and, therefore, could not determine whether the applicable tobacco taxes on imports by unregistered importers had been declared and paid.

In 1998, the Ministry made a one-time request to the Canada Customs and Revenue Agency for the list of imports by unregistered importers for the past several years. The Ministry then audited five of the unregistered importers to determine whether the correct amount of tax had been paid. All five audits resulted in assessments for taxes due ranging from \$3,600 to \$297,000 and totalling \$450,000. We understand that no such audits have been undertaken since that time.

Recommendation

To ensure that tobacco product import and export reports are complete and accurate and that the correct amount of tax has been declared and paid, the Ministry should:

- **obtain the required information from all inter-jurisdictional transporters or, if that information is unavailable, obtain other evidence, such as customs declarations, to assess the completeness and accuracy of reported imports and exports; and**

- regularly obtain information from the Canada Customs and Revenue Agency detailing tobacco-product imports by unregistered importers and use it to determine whether the correct amounts of tobacco tax have been declared and paid.

Ministry Response

The Ministry will communicate and reinforce the reporting requirements for manufacturers, importers, exporters, and inter-jurisdictional transporters. Operational procedures will be enhanced to include cross-checks between transporter and importer/exporter returns.

Customs reports of tobacco products imported will be requested on a regular basis through the exchange-of-information agreement with the Canada Customs and Revenue Agency. In addition, the Ministry has been reviewing the border collection agreement to propose enhancements that will assist in our enforcement. Among other things, the enhancements include automatic electronic forwarding of customs reports. As in 1998, we will use these reports to assist in the selection of audits and to assess any liabilities.

Cigar Taxes

Although a population-based allocation system that limits the quantity of tax-exempt cigarettes that can be sold on native reserves has been established by regulation under the *Tobacco Tax Act*, no similar allocation system has been established for the sale of tax-exempt cigars.

According to information provided to us by the Ministry, approximately 27 million cigars or 84% of all cigars sold in Ontario were sold on reserves exempt of tax. The Ministry estimated that 90% of these tax-exempt cigars were sold on just two reserves.

Recommendation

To ensure that the quantity of tax-exempt cigars sold on native reserves is reasonable, the Ministry should consider the need for an allocation system for cigars similar to the one in place for the sale of tax-exempt cigarettes, and if considered advisable, initiate its development.

Ministry Response

Regulatory change would be necessary to effect the extension of the allocation system to cigars. The Ministry will study the advisability of moving to such a system.

Tobacco Tax Increases

To reduce the incidence of smoking and to raise additional revenue, the federal and provincial governments each increased tobacco taxes by \$2 per carton of cigarettes as of April 6, 2001. Historically, such tax increases have resulted in increased illegal activities whereby cigarettes previously exported tax free to the United States are smuggled back into the province.

To combat such activities, the federal government has also introduced a tax on exported cigarettes as follows:

- \$10 per carton of cigarettes on quantities up to 1.5% of a manufacturer's production in the previous year; and
- \$22 per carton on quantities in excess of 1.5% of production in the previous year.

The Ministry expects that the introduction of the federal export tax will provide a powerful deterrent to the resurgence of smuggling networks such as those that flourished in the early 1990s.

SECURITY REQUIREMENTS

Effective January 1, 1992, the *Gasoline, Fuel, and Tobacco Tax* acts required that registrants—such as manufacturers, collectors, and importers—post financial security with the Ministry. The amount of required security varies with the type of registrant but is generally equal to the greater of the average three months' tax paid in the preceding year, or \$1 million in the case of manufacturers and collectors and \$10,000 to \$500,000 for importers. We understand that registrants in operation prior to January 1, 1992 were exempted from the security requirements as follows:

- *Gasoline Tax* and *Fuel Tax* act registrants—provided they received ministry approval; and
- *Tobacco Tax Act* registrants—provided they entered into a Remittance Agreement with the Ministry.

One of the primary risks to the Ministry of not having adequate security is that a collector could collect tax but not remit the tax collected to the Ministry. By having the required security deposit, the Ministry minimizes this financial risk.

We reviewed the files for a number of exempted registrants and found that the Ministry:

- could not provide evidence of ministry approvals for the *Gasoline Tax* and *Fuel Tax* act registrants exempted; and
- could not locate the required Remittance Agreements for about one quarter of the *Tobacco Tax Act* registrants exempted.

In addition, the Ministry's continuing to exempt pre-1992 registrants is questionable in our view, particularly since all others are required to post security in the stipulated amounts.

We also reviewed a sample of files for registrants that had provided security and found that almost one third of them had not provided security in at least the minimum required amount. The shortfalls ranged from \$480,000 to \$13 million and averaged approximately 60% of the required amount.

Recommendation

To help protect its financial interests, the Ministry should

- consider whether its best interest would be served by requiring security from all registrants; and
- ensure that all registrants required to post security do so in the stipulated amount.

Ministry Response

The Ministry will: (1) review the administrative “grandfathering” concession made available to some registrants; and (2) increase the frequency of review of the quantum of security provided by existing registrants.

GASOLINE, DIESEL FUEL, AND TOBACCO TAX AUDITS

As noted previously, the Branch did not have a desk audit function at the time of our audit. That fact, together with our concerns about the Branch’s processing of gasoline, diesel fuel, and tobacco tax returns, make field audits all the more critical for detecting any undeclared or unremitted tax. We noted that for the last four years, the Branch’s 22 gasoline and fuel tax field auditors generated an average of \$8.7 million per year in assessments, and its two tobacco tax auditors generated an average of \$3.9 million per year in assessments.

The Branch’s Audit Procedures Manual sets out the type of work required during a field audit. We noted that the manual contains a number of useful audit procedures such as:

- summarizing information on the returns and attached schedules since the time of the last audit to identify any unusual trends, variances, or items requiring a more detailed review;
- confirming sales and purchases between collectors and reconciling them to supporting documentation, such as sales invoices and loading tickets; and
- reconciling imports and exports to third-party documents, such as sales agreements and customs documentation.

The Audit Procedures Manual also states that unreconciled items may be assessed tax for administrative purposes to prevent them from becoming statute barred (that is, to prevent them from becoming ineligible for reassessment by exceeding the time periods stipulated by legislation).

We reviewed a sample of audit working paper files for smaller audits and found that they were generally completed satisfactorily and in compliance with the requirements of the Ministry’s Audit Procedures Manual. However, working paper files for audits of large collectors were less than satisfactory and did not clearly determine whether or not the correct amount of tax had been declared and paid. Deficiencies we noted in our review of large collector audit files included the following:

- We found no evidence that the auditors had performed the required variance analyses to identify areas of risk in need of further review.
- File documentation was generally poor. For example, most audit files did not contain audit programs detailing the type and extent of testing to be performed.
- In most cases, audit work consisted of comparing information between a collector's various internal reports rather than using third-party documentation for independent confirmation, as required by the Audit Procedures Manual.
- In almost all cases, we found little evidence of supervisory input at the planning stage or verification of the audit work done.

Even in cases where large discrepancies were identified during an audit, we often found no evidence that the discrepancies had been followed up on and resolved.

We also noted that the Branch generally tried to conduct audits on a three- to four-year cycle because tax returns become statute barred after four years. However, we found that the three, large, domestic tobacco-product manufacturers had not been audited for an extended period of time; the last audits had been completed in 1988, 1994, and 1996, respectively. As a result, tax returns for these manufacturers have been statute barred for periods ranging from one to nine years.

Recommendation

To ensure that audit work is completed satisfactorily and clearly determines whether or not the correct amount of gasoline, diesel fuel, and tobacco tax has been declared and paid, the Ministry should:

- **develop detailed audit programs that comply with the work requirements of the Ministry's own Audit Procedures Manual for inclusion in each audit file;**
- **encourage supervisory input at the planning stage to ensure high-risk areas are appropriately addressed;**
- **ensure that the required work is completed satisfactorily and that any unresolved variances are assessed when warranted to prevent the results of further audit work from becoming statute barred; and**
- **complete audits on a three- to four-year cycle to ensure that returns do not become statute barred.**

Ministry Response

The Ministry began an overhaul of audit programs prior to the commencement of this audit and this overhaul is now substantially complete. The revised audit programs, when fully implemented in the current fiscal year, will provide for better documentation of supervisory input at the planning stage and of the work done, such as the resolution of identified variances.

The Ministry's audit plan incorporates a four-year cycle for large collectors. The scope of these audits will be refined to better respond to identified risks including potential statute barring of material tax liabilities.

FIELD INSPECTIONS

The Branch’s Field Inspection Unit is responsible for the following activities:

- roadside inspections of the running tanks on approximately 1.2 million diesel-powered vehicles to ensure that they are using only clear, tax-paid fuel—where the use of coloured, tax-exempt fuel is detected, further investigation is to be undertaken;
- terminal and bulk storage facility inspections at approximately 230 locations to ensure that fuel to be used for tax-exempt purposes has been correctly dyed;
- the testing of fuel samples from 1,700 service stations to ensure that clear fuel available for sale has not been previously dyed or otherwise tampered with; and
- tank wagon inspections at border points and within Ontario to ensure that the products transported have not been misdeclared.

All of these activities are carried out by just 12 inspectors, each of whom is assigned to a specific geographic area. For example, one inspector covers a large area from south of Lake Simcoe to Lake Ontario that includes Toronto. In our view, the number of inspectors is not sufficient to encourage voluntary compliance on a broad scale.

For the 1999/2000 fiscal year, all inspection activities combined resulted in assessments of approximately \$260,000 in additional taxes and \$80,000 in fines. In addition, the inspectors referred files for audit, the results of which are not included in these statistics.

The Ministry had not formally assessed the risks associated with various tax evasion schemes to determine the number, type, and the regional locations of inspections necessary to mitigate such risks. However, it had established total annual performance targets for the inspection function based on what was thought to be achievable given the available staff resources.

A comparison of actual inspection activities to the total number of activities planned indicated that the number of actual activities was often significantly lower than the number planned, as the following table demonstrates.

Comparison of Actual to Planned Inspection Activities, 1999/2000

Inspection Activities	Actual # of Inspections	Planned # of Inspections	Actual as a % of Planned Inspections
roadside inspections	2,956	3,600	82
fuel storage inspections	277	668	41
terminal and bulk storage facility inspections	810	1,032	78
propane facility inspections	55	288	19
tank wagon inspections	128	276	46
tobacco retailer inspections	199	528	38

Source of data: Ministry of Finance

We also noted that:

- Over the last four years, although the number of inspectors has remained constant, the total number of inspections has decreased by over half while taxes assessed have increased slightly.
- The Ministry did not track results by inspector, type of inspection, or inspection location to determine whether its resources were being effectively deployed.

Recommendation

To maximize the benefits of its inspection program for encouraging compliance with gasoline, diesel fuel, and tobacco tax requirements, the Ministry should:

- **assess whether the number of inspectors is sufficient to promote voluntary compliance on a broad scale;**
- **base its performance targets for the type, number, and location of inspections to be undertaken on the periodic assessment of known risks of tax evasion schemes; and**
- **monitor the results of inspections by type, number, and location, and periodically make any changes needed to ensure that its resources remain effectively deployed.**

Ministry Response

The Ministry will assess whether the number of inspectors is sufficient, refine performance targets, and monitor results.

BUSINESS PROCESS RE-ENGINEERING

Gasoline, diesel fuel, and tobacco tax-related returns and supporting schedules are filed and processed by the Branch in paper form, which requires branch staff to spend much time handling the voluminous amount of paper involved. However, the Ministry has recognized that, because of the Branch's limited staff resources and the preponderance of registrants that rely heavily on information technology, it needs to revise its own business processes by making more extensive use of information technology and developing a desk audit function.

In our 1995 report, we raised this issue and recommended that the feasibility of changing from a paper-based system to one based on electronic data interchange be investigated.

In 1997, the Ministry initiated a re-engineering project for the Branch's business processes. The project was initially scheduled for completion in 2001 and, among other things, was to include the development of such features as:

- electronic filing of tax returns and other required information;
- electronic tax return processing; and

- extensive data comparison and analyses for verifying the information provided and, for example, enhancing audit selection.

At the time of our audit in early 2001, the Ministry had developed information technology applications such as integrating the tax-refund claim processing function and monitoring tax-exempt sales of tobacco products to natives on reserves. However, work on the features noted above had not yet begun. The Ministry now expects that these features will not be completed before the end of the 2002/03 fiscal year.

Recommendation

Given that many of our preceding recommendations could be implemented most efficiently and effectively through the use of information technology, the Ministry should give priority to completing its business re-engineering project as soon as possible.

Ministry Response

Priority will be given to completing our business re-engineering project.

EFFECTIVENESS MEASURES

The commodity tax systems are essentially based on self-assessment by collectors whereby they are to voluntarily declare taxable sales and remit the correct amount of tax. The objective of the Branch’s administrative policies and procedures is to encourage such voluntary compliance and, at the same time, minimize tax evasion.

The primary indicator of the degree of voluntary compliance and therefore of the success of the Branch’s administrative policies and procedures, is the extent of tax evasion over time. The Ministry’s Macroeconomics Analysis and Policy Branch is responsible for developing revenue forecasts and estimating potential tax losses attributable to tax evasion. However, our discussions with staff from that Branch indicated that no studies of tax evasion as it relates to commodity taxes had been conducted since the time of our last audit in 1995.

Aside from determining the nature and extent of tax evasion, the Motor Fuels and Tobacco Tax Branch could develop more direct performance indicators that, over time, could also provide insight into the impact of branch activities on voluntary compliance and the deterrence of tax evasion.

In our 1995 report on this program, we made similar observations and the Ministry responded that it was in the process of developing a management information system that would measure the effectiveness of its compliance and enforcement activities. However, we found that such a system had not yet been developed.

Recommendation

To determine the extent to which it is meeting its objectives of encouraging voluntary compliance with and deterring the evasion of gasoline, diesel fuel,

and tobacco taxes, the Ministry should develop and implement the necessary performance indicators.

Ministry Response

The Ministry will consider the development of additional performance indicators to determine the impact of ministry activities on voluntary compliance.