

Gasoline, Diesel-fuel, and Tobacco Tax

Follow-up on VFM Section 3.10, *2008 Annual Report*

Background

In the 2009/10 fiscal year, the Ministry of Revenue (Ministry) collected taxes on tobacco, gasoline, and diesel fuel totalling approximately \$4 billion (\$4.3 billion in 2007/08), or about 6.2% of the province's total taxation revenue from all sources in both years.

At the time of our audit in 2008, we stated that the tobacco tax gap—the difference between the amount of tax that should be collected and the amount that is collected—had increased significantly since our previous audit of tobacco tax collection in 2001. In fact, it was our view in 2008 that the tobacco tax gap for the 2006/07 fiscal year could well have been in the \$500-million range, even when taking into account estimated declines in consumption levels.

Regulations under Ontario's *Tobacco Tax Act* limit the total number of tax-free cigarettes a First Nations reserve may purchase. However, a number of manufacturers and wholesalers with operations on reserves sold significantly more cigarettes to reserves than was reasonable. For instance, one of these manufacturers/wholesalers sold, to 16 reserves, an average of 27 cartons per month for every adult band member who smoked, and to another reserve over 400 cartons per month. These

quantities are well beyond what could be reasonably assumed to be for personal use and almost certainly included cigarettes destined for sale to non-band members.

Ontario is one of just three jurisdictions in Canada—Nunavut and the Yukon Territory are the others—that do not limit sales of untaxed cigars on First Nations reserves. It was our view, as well as the Ministry's, that the tax forgone on cigar sales to and from reserves is significant. For instance, in the 2006/07 fiscal year, approximately 76 million cigars—over and above the estimated reserve consumption—were sold tax-exempt to First Nations reserves, with the estimated forgone tax exceeding \$25 million.

We also stated in 2008 that it was necessary for the Ministry to make significant improvements to its information technology systems, along with changes to its policies and procedures, before the Ministry could be assured that the correct amount of tobacco, gasoline, and diesel-fuel taxes was being declared and paid in accordance with statutory requirements.

For reasons of administrative efficiency, the Ministry has designated manufacturers and certain large wholesalers as tax collectors, responsible for collecting and remitting to the Ministry the applicable amount of commodity tax. These collectors generally charge tax on sales to organizations or

persons who do not have collector status, and they also pay and remit tax on products they themselves consume. As a result, the vast majority of commodity taxes are collected and remitted to the province by relatively few collectors. However, at the time of our 2008 audit, there was no process in place to assess the completeness and accuracy of information reported in returns for tobacco, gasoline, and diesel fuel. For example, the Ministry had no way to reconcile reported tax-exempt purchases and sales between designated collectors, or of verifying imports and exports reported by collectors against the independent information submitted by inter-jurisdictional transporters.

Our review of the Ministry's audit coverage for the largest and riskiest collectors noted that although all seven of the large gasoline and diesel-fuel tax collectors had been audited every four years as planned, only a few of the 38 large tobacco tax collectors had been audited at least once every four years as planned.

We made a number of recommendations for improvement and received commitments from the Ministry that it would take action to address our concerns. As well, the Standing Committee on Public Accounts held a hearing on this audit in February 2009.

Status of Recommendations

Information obtained from the Ministry of Revenue suggests that the Ministry has made good progress in implementing many of our recommendations. For example, since our 2008 audit, the Ministry has made a significant investment in the ONT-TAXS computer system, which has significantly improved its ability to administer taxes and has enhanced customer service. However, more needs to be done to fully address all areas satisfactorily. As well, because implementation of some recommendations will require co-ordination with other governments, provincial ministries, and enforcement agencies,

full implementation of all recommendations will take more time. The status of action taken on each of our recommendations at the time of our follow-up was as follows.

TAX GAP

Recommendation 1

In order to reduce the amount of tobacco tax revenue being forgone, the Ministry of Revenue should assess its policy options for mitigating the incentives for the smuggling and sale of illegal tobacco. Options could include increased sanctions for non-compliance with, and more targeted enforcement of, provisions of the Tobacco Tax Act.

Status

The Ministry informed us that it was co-ordinating its efforts to identify and implement enhanced measures to combat the illegal tobacco trade in Ontario with other levels of government and enforcement agencies. Examples of this co-ordination include:

- engaging First Nations communities in discussions of shared objectives and joint strategies and actions;
- providing greater public education about illegal tobacco and associated risks and penalties; and
- working with federal agencies, the province of Quebec, and other Ontario ministries to identify best practices and to enhance co-ordinated actions.

The Ministry advised us that it was in the process of establishing clear objectives and expected results for this work, and that it was developing other strategies and actions that could be taken. In April 2010, for example, the Ministry established a Tax Programs Project Office, which has a team working under the leadership of a dedicated Assistant Deputy Minister who co-ordinates the efforts of a number of ministries and other organizations to implement the government's plan to address the challenges of illegal tobacco.

In addition, legislation has been strengthened to provide for increased sanctions for non-compliance. Bill 162, which received Royal Assent on June 5, 2009, included:

- new enforcement provisions aimed at individuals, where there are reasonable and probable grounds to believe that the individuals have contravened the *Tobacco Tax Act*;
- authority for the courts to suspend the driver's licence of any person convicted of offences under the *Tobacco Tax Act* involving the use of motor vehicles in the commission of the offence; and
- new provisions that prohibit the possession of any quantity of unmarked cigarettes, unless permitted under the *Tobacco Tax Act*.

Notwithstanding the fact that smoking continues to decline (as reported by the Ministry of Health Promotion), enhanced enforcement activities by the Ministry and its partners have resulted in an increase of \$40 million in tobacco tax revenue over the previous fiscal year, as indicated in the 2009–2010 Public Accounts.

BORDER SECURITY AND CONTROL OF THE ILLEGAL TOBACCO TRADE

Recommendation 2

The Ministry of Revenue should consult and work closely with the Canada Border Services Agency, the RCMP, and the OPP to bring to bear the resources and policy changes necessary to deal more effectively with the importation of illegal cigarettes and other tobacco products into Ontario.

Status

The Ministry informed us that the newly established Intelligence Assessment Unit within its Special Investigations Branch (SIB), along with recent collaborative efforts involving other ministries and enforcement agencies, has led to positive results. For example:

- In February 2010, the SIB joined the Cornwall Regional Task Force, which includes the

RCMP and the OPP Contraband Enforcement Team, to help combat the illegal tobacco trade in the Cornwall area. The SIB is committed to this initiative, which at the time of our follow-up continued to have a physical presence in the Cornwall area. The Ministry informed us that it intends to assess the effectiveness of the initiative and determine if a permanent presence is warranted.

- SIB also placed an intelligence/tobacco analyst in the RCMP's Cornwall Detachment in May 2010 for a period of between nine and 12 months. The analyst was to help identify trends in illegal border activity, which will allow for improved enforcement targeting based on assessed risk.
- Six recently completed operations in high-traffic areas for illegal tobacco, conducted in co-operation with the OPP, targeted consumers of illegal tobacco and resulted in 338 stops and the issuing of 33 summonses.

In addition, we were advised that during the 2009/10 fiscal year, total convictions under the *Tobacco Tax Act* increased substantially over the previous year.

TOBACCO ALLOCATION SYSTEM ON FIRST NATIONS RESERVES

Recommendation 3

To help meet the intent of the Tobacco Allocation System for First Nations reserves, and to prevent the diversion of untaxed cigarettes to off-reserve sale and consumption, the Ministry of Revenue should ensure that a reserve's purchases from all sources, including on-reserve manufacturers and wholesalers, is limited to the tobacco allocation assigned to that reserve. The Ministry should also consider other options such as greater incentives to First Nations band councils to reduce or eliminate the on-reserve production or purchase of cigarettes for off-reserve consumption.

Status

The Ministry informed us that it has been working with First Nations elected band councils to help ensure compliance with the Tobacco Allocation System. For example, the Ministry has begun discussions and joint work with some First Nations to improve the allocation system and identify other strategies for fighting illegal tobacco activities. The Ministry was also working with the Chiefs of Ontario First Nations to identify areas for joint analysis, research, and public education.

As of March 2010, 85 out of 133 First Nations had signed a Retail Agreement with the Ministry. Under these agreements, band councils assume more control and decision-making and agree to monitor the sales of tax-exempt cigarettes and tobacco to ensure that such sales are made only to First Nations people.

In addition, the Ministry's tax administration system, known as ONT-TAXS, was implemented for the tobacco, diesel-fuel, and gasoline tax programs in April 2010. It is expected to provide more efficient tracking and analysis of the cigarette allocation system by automatically identifying tobacco wholesalers who sell more than their allocation limit for a particular reserve and by producing monthly over-purchase reports.

However, the Ministry acknowledged that much more needs to be done to prevent untaxed cigarettes from being sold off-reserve. The Ministry's recent initiatives notwithstanding, additional enforcement efforts will be needed to ensure that a reserve's actual purchases from all sources do not exceed its assigned tobacco allocation.

CIGAR TAXES

Recommendation 4

To help ensure that the number of tax-exempt cigars sold to First Nations reserves is reasonable and is not diverted to untaxed off-reserve sale and consumption, the Ministry of Revenue should develop and implement an allocation system for cigars similar to

that for cigarettes, as is done in most other Canadian provinces, and ensure that it is adhered to.

Status

Although the Ministry had not yet developed an allocation system for cigars at the time of our follow-up, it informed us that it was reviewing options and considering additional strategies for limiting the sale of untaxed cigars at the wholesale level. The Ministry indicated that it first planned to update and improve its current cigarette allocation system, which could then provide a model for a cigar allocation system.

CIGARETTE PRODUCTION AND CONTROL

Recommendation 5

The Ministry of Revenue should assess its various options for ensuring that all cigarettes manufactured and packaged for taxable consumption in Ontario are accounted for and the applicable tax paid. If it decides to continue the use of yellow tear-tape to mark cigarette packages for taxable consumption in Ontario, it should:

- *receive sufficiently detailed information about yellow tear-tape material sold to, and acquired and used by, cigarette manufacturers; and*
- *reconcile the information received to assess the reasonableness of the reported use of yellow tear-tape material in relation to reported taxable sales.*

Status

At the time of our follow-up, the Ministry continued to require the use of yellow tear-tape to mark cigarette packages for taxable consumption in Ontario. We were advised that since our 2008 audit, the Ministry has begun receiving monthly reports from the tear-tape manufacturers on the production and sales of yellow tear-tape material supplied to cigarette manufacturers. The Ministry reviews this information to identify areas of risk and potential audits of manufacturers licensed to mark tobacco products with tear-tape. One such audit was under way at the time of our follow-up and was to include

a detailed reconciliation of yellow tear-tape purchased by that manufacturer, compared to reported taxable sales.

As well, the Ministry informed us that a matching process within the ONT-TAXS system flags inventory/use discrepancies between the tear-tape manufacturers' reported sales and the tear-tape used in cigarette manufacturing.

TOBACCO TAX-RETURN PROCESSING

Recommendation 6

To help ensure that all cigarette and cigar production and imports are accounted for, and to help assess the reasonableness of reported taxable sales, the Ministry of Revenue should ensure that it:

- receives and retains all required tax returns, and that the returns are complete and include all the required detailed schedules;
- thoroughly assesses on a sample basis the completeness and accuracy of the reported information; and
- diligently follows up on significant, unusual, or otherwise questionable items.

Status

Following the recommendations of our 2001 Annual Report, the Ministry introduced additional registration and reporting requirements for manufacturers and transporters of tobacco products. As an interim measure, manual checklists were then developed to help verify the completeness of information on returns and the ultimate tax liability declared.

The Ministry informed us that in April 2010, the tobacco tax program was successfully transferred to the ONT-TAXS computerized information system using revised returns and schedules that facilitate reconciliation of key data elements. As a result:

- applicable information from tax returns and schedules is now retained;
- the reported information is better assessed for completeness and accuracy; and

- where possible, manual processes for return processing and verification have been automated to enhance efficiency and effectiveness.

We were also advised that the Ministry's internal audit unit was developing a strategy for reconciling cigarette and cigar production and imports with reported taxable sales on a sample basis.

GASOLINE AND DIESEL TAX-RETURN PROCESSING

Recommendation 7

To help ensure that all gasoline and diesel production can be accounted for, and to help assess the reasonableness of reported taxable sales, the Ministry of Revenue should ensure that:

- all returns received are completed and include, for example, all required detailed schedules and documentation;
- it thoroughly assesses on a sample basis the completeness and accuracy of the reported information;
- it diligently follows up on significant, unusual, or otherwise questionable items; and
- it expedites its planned implementation of a computerized tax-return-processing function.

Status

The Ministry informed us that as an interim measure, procedures were updated and manual checklists developed to assist with the verification of tax liability and the completeness of information on the tax returns.

In April 2010, the gasoline and diesel-fuel tax programs were successfully transferred to the ONT-TAXS computerized information system using revised returns and schedules that facilitate reconciliation of key data elements, the benefits of which are similar to those noted earlier for tobacco tax returns.

The Ministry also advised us that questionable items are regularly referred to audit for follow-up.

GASOLINE TAX EXEMPTIONS

Recommendation 8

To help ensure that gasoline tax refunds are only issued for eligible gasoline purchases, the Ministry of Revenue should:

- exercise more vigilance in its review of refund vouchers and, where information is questionable or missing, ensure that an appropriate follow-up with the retailer is done prior to allowing the claim; and
- strengthen its procedures for the issuance and cancellation of First Nations Certificates of Exemption.

Status

The Ministry informed us that it began a phased rollout of an electronic refund system in September 2008. In April 2010, this system became part of the ONT-TAXS system, with 15 out of 146 reserve retailers now submitting tax-refund claims electronically. The Ministry advised us that the electronic system enhances its ability to validate claims and identify questionable items.

The Ministry was also working with Indian and Northern Affairs Canada to identify opportunities to enhance the verification of Gasoline Tax Exemptions based on a modernized Status Indian identification card.

GASOLINE, DIESEL, AND TOBACCO TAX AUDITS

Recommendation 9

To help ensure that audit work is satisfactorily planned and completed, and clearly determines and demonstrates whether the correct amount of tobacco, gasoline, and diesel tax has been declared and paid, the Ministry of Revenue should:

- complete audits of the largest and higher-risk designated collectors within the planned four-year periods to ensure that the audits do not fall outside the legal time limits for reassessment;

- ensure that all working-paper files are retained and clearly document the work done and decisions made; and
- require supervisory review and approval and documentation of decisions made, both at the planning stage of an audit and at the conclusion of fieldwork, to help ensure that work is focused on the areas of highest risk of non-compliance and that the work necessary to mitigate the identified risk is adequately completed.

Status

At the time of our follow-up, the Ministry had not yet completed audits on many of the largest and higher-risk tobacco tax collectors within the planned four-year period, but we were informed that it planned to do so by 2013. Future audits will be selected using a risk-based audit selection process.

We were also advised that risk-based audit programs have been developed to help ensure that audit work is focused on the areas of highest risk of non-compliance and that training on the new programs has been provided to staff. The Ministry also developed a file documentation package that will retain the working papers electronically and forward them to managers for review and approval.

In addition, audit managers now have a higher level of responsibility to approve and monitor audit work and to document direction and decisions made regarding the audit. An “Audit Manager File Review Template/Checklist” has also been developed and is to be completed and kept as part of the audit file.

FIELD INSPECTIONS

Gasoline and Diesel Inspections

Recommendation 10

To maximize the benefits of its diesel-fuel inspection program, the Ministry of Revenue should:

- formally assess the likely risk and extent of the use of untaxed fuel in vehicles operating on provincial roads and highways;

- *develop an inspection strategy that is tailored to the risks identified and that has the best chance of deterring or identifying the illegal use of untaxed fuel; and*
- *assess the results of improving its enforcement efforts before concluding that more inspectors are needed.*

Status

The Ministry informed us that it had completed an operational review of the diesel-fuel inspection program in March 2010 and developed a risk-based model to identify areas of significant risk for inspection. An inspection strategy was also developed to address the risks identified in order to deter the illegal use of untaxed fuel, and inspections were being conducted in accordance with this strategy.

The Ministry also reviewed the geographical territories assigned to its inspectors in the fall of 2008 and realigned some of the territories in order to optimize inspection coverage across the province. This realignment eliminated the need for additional inspectors.

Tobacco Retailer Inspection Program

Recommendation 11

The Ministry of Revenue should assess whether the planned expansion of the Tobacco Retailer Inspec-

tion Program is the most effective way to detect and deter sales of untaxed cigarettes, or whether a more concentrated effort at the point of manufacture or importation of untaxed cigarettes into Ontario would yield a better return.

Status

It was the Ministry's view that the Tobacco Retailer Inspection Program (TRIP) has proven effective in limiting the quantity of untaxed/illegal cigarettes available to consumers at the retail level. Although the Ministry is constantly assessing TRIP, it still needs to assess whether this program is the most effective way to detect and deter sales of untaxed cigarettes.

A risk-based tobacco inspection strategy that eliminated the need to visit every retailer each year has been developed and implemented. Since our 2008 audit, TRIP has been conducting approximately 600 inspections per month, or about 7,200 annually, which results in coverage of about half the retailer base each year.

TRIP staff were also assisting the SIB and the OPP with roadside inspections where reasonable grounds exist to believe that a vehicle contains illegal tobacco. These initiatives were focused on consumers with the explicit aim of altering behaviours to help reduce purchases of illegal tobacco.