

3.02—Corporations Tax

BACKGROUND

Generally, the *Ontario Corporations Tax Act* imposes taxes on all corporations that have a permanent establishment in Ontario or that owned and received income from or disposed of real property in Ontario as follows:

- Income tax is currently payable at a general rate of 12.5% of taxable income earned in Ontario. On the first \$280,000 of active business income earned by a Canadian-controlled private corporation (CCPC), this rate is reduced by 6.5%. For income earned from manufacturing and processing that is not eligible for the CCPC reduction, this rate is reduced by 1.5%.
- Capital tax is payable on a corporation's taxable paid-up capital (generally 0.3% of taxable capital in excess of \$5 million).
- Premium tax is payable on insurance policies written for persons residing in and property situated in Ontario at a rate of 2% to 3% of gross premiums.
- Corporate minimum tax is payable by certain larger corporations or associated groups that have annual gross revenues in excess of \$10 million or total assets in excess of \$5 million.

We note that the Ontario basic corporations income tax rate of 12.5% is, on average, 3% lower than the comparable rates in the other provinces.

Ontario, Quebec, and Alberta are the only three provinces in Canada that require corporations to file a provincial corporations tax return directly with the province. The Canada Customs and Revenue Agency (CCRA) collects provincial corporations taxes on behalf of the other provinces through the federal corporations tax system. The CCRA also provides Ontario with daily electronic transmissions of data regarding federal corporations tax assessments and reassessments that are reviewed to determine their effect on provincial tax owed.

Certain governmental and non-profit organizations, such as municipalities, Crown corporations, and registered charities, are exempt from Ontario corporations tax and are therefore not required to file a Ontario corporations tax return.

For the 2001/02 fiscal year, the province collected approximately \$6.6 billion in corporations taxes. Although the Ministry was not able to provide us with a summary of the

types of taxes making up this total, we noted that, for the 2000/01 fiscal year, the total of approximately \$9.2 billion in corporations taxes collected by the province consisted of \$7.2 billion in corporations income tax; \$1.3 billion in capital tax; \$534 million in premium tax; and \$139 million in corporate minimum tax. Collectively these corporations taxes represent approximately 19% of the total tax revenue collected by the Ministry during the year. They also represent a significant increase from the \$5.4 billion in corporations taxes collected at the time of our last audit of this program in 1996.

The Corporations Tax Branch (Branch) of the Ministry of Finance has primary responsibility for the administration and, together with staff at the four regional tax offices, the enforcement of the *Ontario Corporations Tax Act*. Most of the 770 staff involved in corporations tax collection work either in the operations or audit areas of the Ministry. Approximately 165 operations staff are located in Oshawa and primarily process tax returns and maintain corporations account information. A total of about 500 audit staff are located in the Ministry's head office in Oshawa and four regional tax offices in North York, Mississauga, London, and Ottawa. Branch expenditures for the year totalled \$45.2 million, of which almost 90% was for staff salaries and benefits.

The Branch's activities are supported by the comprehensive computer-based Integrated Tax Administration System, which facilitates the maintenance of the corporations tax database, the processing of tax returns, the issuing of assessments, and the performance of the accounting function for taxpayer accounts and provides other information as may be required from time to time.

The Branch is also supported by other ministry branches: the Revenue Operations and Client Services Branch receives and processes tax receipts; the Collections and Compliance Branch pursues outstanding tax balances and overdue returns; the Special Investigations Branch investigates complex cases of suspected non-compliance; and the Tax Appeals Branch handles objections and appeals filed by taxpayers.

AUDIT OBJECTIVE AND SCOPE

The objective of our audit was to assess whether the Ministry had adequate policies and procedures in place to ensure that the appropriate amount of corporations tax is declared and remitted by taxpayers in accordance with statutory requirements.

Our audit work included a review and analysis of relevant ministry files and administrative policies and procedures as well as detailed interviews with appropriate staff at the Corporations Tax Branch and regional tax offices, the Revenue Operations and Client Services Branch, the Collections and Compliance Branch, the Special Investigations Branch, and the Tax Appeals Branch. We also obtained relevant information from the CCRA and held discussions with staff from other provincial finance ministries.

Our audit work covered the period up to March 31, 2002, with emphasis on the policies and procedures in place with respect to corporations tax revenues processed in the 2001/02 fiscal year. Our work was primarily conducted in the period from September 2001 to the beginning of the Ontario Public Service Employees' Union strike in February 2002. We also obtained information from telephone calls made both during and after the strike and meetings with ministry staff held from the time the strike ended in early May up to June 2002.

Our audit was conducted in accordance with the standards of 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.

During the planning phase of our audit, we reviewed prior audit reports issued by the Ministry's Internal Audit Services Branch with respect to the Corporations Tax program to determine whether the work of the branch could be relied on to reduce the extent of our work. As a result, we relied on the Internal Audit Services Branch's work on both the processing of corporations tax receipts by the Revenue Operations and Client Services Branch as well as the collection and write-offs of accounts in default by the Collections and Compliance Branch and carried out no further audit work in these areas. We also reviewed two other reports by the Internal Audit Services Branch on the Corporations Tax Branch in Oshawa and one regional tax office. However, we decided not to rely on these reports since the scope of our audit and the approach we took were significantly different from those of the Internal Audit Services Branch.

OVERALL AUDIT CONCLUSIONS

Many corporations voluntarily declare and remit the correct amount of corporations tax. This fact, combined with the strong economy of the late 1990s, contributed significantly to the very substantial increase in corporations tax revenues from \$5.4 billion in the 1995/96 fiscal year (reported in our last audit in 1996) to \$6.6 billion in the 2001/02 fiscal year (\$9.2 billion in the 2000/01 fiscal year).

However, where corporations did not voluntarily comply, the Ministry did not have adequate policies and procedures in place to ensure that the appropriate amount of corporations tax was being declared and remitted by taxpayers in accordance with statutory requirements. Although research by the Canadian Tax Foundation on the growth of the underground economy indicates that the tax gap—the difference between the amount of all taxes actually collected and the amount that should be collected—is increasing, the Ministry did not assess or evaluate the extent to which the tax gap affected provincial corporations tax revenue. The Ministry also did not assess the risk of significant non-

compliance for all corporations that had filed a return and therefore did not select for audit those with the highest overall risk. It is our view that the tax gap with respect to provincial corporations tax may well be substantial.

As an example of the extent to which corporations did not voluntarily comply, we found that of the 763,000 corporations with active accounts, at least 355,000 corporations—or almost half—were in default of filing required returns. The total number of outstanding returns for all the years in which those corporations failed to file was at least 930,000. Both the number of corporations in default of filing and the number of outstanding returns have significantly increased since 1996, when one in five active corporations failed to file and the number of outstanding returns was 128,700. These increases are generally attributable to the Ministry's reduced efforts in recent years to follow up on overdue returns, the new annual EFF filing requirement introduced in January 2000, and the significant increase in the number of active accounts. We also noted that:

- Although information about corporations has been provided by the Ministry of Consumer and Business Services (MCBS) to the Branch since the 1970s and has been used to automatically update the corporations tax roll on a weekly basis, the Ministry does not regularly compare all active registrants in the MCBS database with those in the corporations tax roll to ensure that all corporations that are registered with MCBS and required to file a corporations tax return continue to be included in the corporations tax roll.

In that regard, we noted that a one-time matching of the MCBS database with the corporations tax roll in 1998 identified 40,600 corporations that were active in the MCBS database but not included in the corporations tax roll. Although we were advised that many of these corporations were subsequently added to the corporations tax roll as a result of either a manual review in 1998 or a one-time data synchronization project in 1999, the Ministry did not have the information necessary to corroborate that assertion.

We also noted that the Ministry was currently negotiating an agreement with MCBS under which the MCBS database and the corporations tax roll would be compared and synchronized every six to 12 months.

- The Ministry closed approximately 40,000 accounts in the Integrated Tax Administration System (ITAS) that maintains the tax roll, which means that a tax return related to any of those accounts would not be expected, and therefore the accounts were not included in the Ministry's statistics on corporations in default of filing; however, since these accounts were still registered as active with MCBS and any of them might still meet the requirements for filing a tax return, tax returns could have been required.

With respect to its function of auditing taxpayer returns, we found the following:

- Although the number of discretionary field and desk audits has increased significantly since the time of our last audit in 1996 (field audits have more than doubled, and there

has been substantial improvement in the number of desk audits), for corporations with annual gross revenues of \$500,000 and over, the number of desk audits completed was only about half of the number planned. For corporations with annual gross revenues of under \$500,000, very few field or desk audits were performed. This limited the degree to which the Ministry could meet its objective of encouraging broad-based voluntary compliance.

Although the Ministry has made a deliberate decision to rely on the CCRA for the audit of smaller corporations, it needs to obtain the necessary information to assess whether such reliance is justified.

- The Ministry's audit file documentation did not clearly demonstrate that the necessary audit work had been adequately planned and performed and that all work had been reviewed and approved by the appropriate manager. When these steps are not taken, the Ministry cannot clearly establish whether or not all taxes owed by the taxpayer audited have been correctly declared and received.
- The Ministry did not provide sufficient training to auditors to promote their technical competence. Insufficient training may limit the ability of auditors to effectively address complex technical and industry-specific tax issues.

We also found that the Branch's Tax Advisory Unit did not respond to all inquiries from other units in the Branch on a timely basis and did not ensure that, where considered necessary, all decisions by the Tax Appeals Branch and the courts regarding audit assessments and audit assessment reversals were summarized and communicated to the appropriate parties.

Overall Ministry Response

We appreciate the Provincial Auditor's various observations and suggestions on the administration of the Corporations Tax program.

The Provincial Auditor raises valid issues, many of which the Ministry is already in the process of addressing. The Ministry will address changes, as recommended in the report, in a way that appropriately incorporates risks and available resources.

DETAILED AUDIT OBSERVATIONS

TAX RETURN FILING

Under the provisions of the *Ontario Corporations Tax Act*, generally all corporations that have a permanent establishment in Ontario or that owned and received income from or disposed of real property in Ontario must deliver a tax return for each taxation year to the

Ministry on or before the last day of the sixth month after the end of the taxation year. Alternatively, a corporation may annually file an exempt-from-filing (EFF) declaration if it meets all of the following requirements:

- It has filed the required federal corporations tax return.
- It has no Ontario-based taxable income and has no Ontario corporations tax payable for the year.
- It was a Canadian-controlled private corporation (CCPC) throughout the duration of the year.
- It has provided the Ministry with its Canada Customs and Revenue Agency (CCRA) business number.
- It is not subject to the corporate minimum tax.

Tax returns can be filed in any one of three formats. About 80% of filed returns are in paper format completed using ministry-approved software; about 10% are in paper format completed using ministry-provided forms; and the remaining 10% are filed on disk.

All returns are received in the Ministry's Revenue Operations and Client Services Branch. This branch ensures that all accompanying payments are deposited and credited to the appropriate taxpayer's account on the day of receipt and then forwards the return to the Operations area of the Corporations Tax Branch for processing.

In the Operations area, approximately 100 data fields from each tax return are keyed into the Integrated Tax Administration System. If some of the information required to issue an assessment is missing or otherwise questionable, the return is referred to the appropriate section for follow-up. If the information provided in the return is complete and accurate, an assessment is normally issued automatically.

Reassessments may be issued at a later date as a result of additional information provided by the taxpayer or as a result of a ministry audit. The *Ontario Corporations Tax Act* permits reassessments to be issued within four years from the mailing of the original notice of assessment for CCPCs and within five years for all other corporations. Thereafter, the taxation period becomes statute barred, which means that the return cannot be reassessed. However, the four- and five-year deadlines can generally be extended if: a waiver is filed by the corporation; the provincial reassessment is to be issued as a result of uncovered fraud; or a federal tax assessment or reassessment was issued.

From January 1, 2000 onwards, the Ministry has been imaging all paper returns processed, as well as supporting documentation submitted with disk-filed returns. Imaged returns are accessible electronically for use by the appropriate staff of the Corporations Tax Branch and regional tax offices.

The Corporations Tax Roll

The Ministry's Integrated Tax Administration System (ITAS) includes a corporations tax roll. As of December 2001, the corporations tax roll contained approximately 1.1 million registrants, of which 763,000 were active and therefore expected to file an annual return. The remaining registrants consisted primarily of corporations whose accounts had been closed.

In general, all corporations that carry on business in Ontario, regardless of where they are incorporated, must register with the Ministry of Consumer and Business Services (MCBS). In addition, corporations must advise MCBS of significant changes in their circumstances (for example, if a corporation amalgamates with another corporation, dissolves, or ceases to operate in Ontario). Since the 1970s, information about corporations provided to MCBS has been used to update the Ministry's corporations tax roll. Currently, on a weekly basis, all changes in a corporation's information that MCBS has received are electronically transmitted to the Ministry, and ITAS automatically updates the tax roll. For example, in the case of an amalgamation of corporations, ITAS opens a new account for the newly amalgamated corporation that is linked to the predecessor corporation accounts, which are then closed. The corporations tax roll may also be updated manually, in cases such as the following:

- when a tax return is received from a corporation that is not already on the tax roll; and
- when electronic transmissions of data regarding federal corporations tax assessments and reassessments are received from the CCRA for corporations that are not already on the tax roll.

However, we noted that the Ministry does not regularly compare all active registrants in the MCBS and ITAS databases and ensure that all corporations registered with MCBS that are required to file a corporations tax return continue to be included in the corporations tax roll in ITAS. A one-time matching of the MCBS database with the ITAS tax roll in 1998 found that there were 40,600 corporations active in the MCBS database that were not set up in ITAS. We understand that, as a result of a one-time data synchronization project in 1999, MCBS data were used to automatically update the corporations tax roll in ITAS. However, information describing how 39,900 of the discrepancies identified in 1998 were resolved and information about the results of the data synchronization was not available at the time of our audit.

We understand that the Ministry is currently negotiating an agreement with MCBS under which the MCBS database and the ITAS tax roll would be compared and synchronized every six to 12 months.

We also noted that the Ministry had manually closed about 40,000 accounts in ITAS that were still registered as active with MCBS and might still meet the requirements for filing a tax return. However, the result of closing the accounts was that these corporations would no longer be expected to file a tax return and would not be included in the Ministry's statistics

on corporations in default of filing tax returns. We understand that in the case of about 15,000 of these accounts, the corporations owed money to the Ministry, and the accounts were closed in part to permit the Ministry to write off the outstanding amounts. However, none of the accounts should have been closed, since, as noted, all were still registered as active with MCBS, and insofar as any of the accounts might still meet the requirements for filing a tax return, tax returns could have been required.

Corporations in Default of Filing

In any year, a certain number of active corporations are in default of filing tax returns, and many of these corporations have failed to file returns over a number of years. For example, ministry records indicated that in 2001, 355,000 corporations, from a total of 763,000 corporations with active accounts, were in default of filing returns. The total outstanding returns for all the years in which those corporations failed to file was 930,000. The following table shows the number of active corporations in default of filing returns each year as well as the overall number of returns not filed over the years the corporations have been in default.

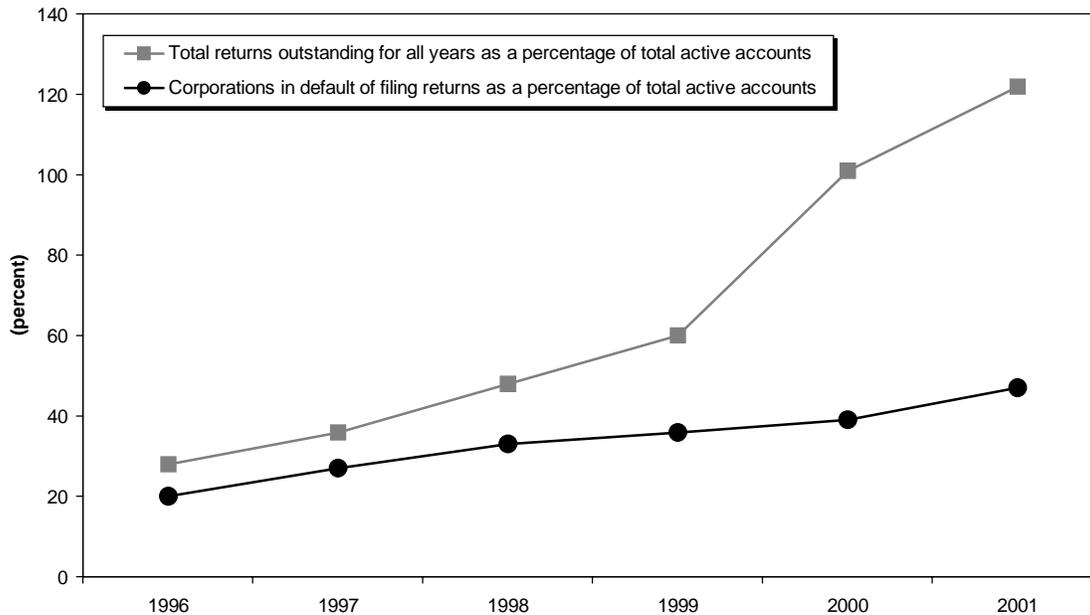
Corporations in Default of Filing Returns, 1996–2001

Taxation Year	# of Corporations with Active Accounts	# of Corporations in Default of Filing Returns	# of Related Returns Outstanding For All Years in Default
1996	464,138	92,950	128,700
1997	545,530	147,700	200,000
1998	563,317	185,000	268,000
1999	605,000	220,000	365,000
2000	685,000	265,000	690,000
2001	763,000	355,000	930,000

Source of data: Ministry of Finance

When the default and returns outstanding data are expressed as a percentage of total active accounts, a dramatic increase since the time of our last audit in 1996 is seen, as in the following line graph.

**Corporations in Default of Filing Returns
as a Percentage of Total Active Accounts, 1996-2001**



Source of data: Ministry of Finance

The Ministry attributed the increase in the number of corporations in default of filing in 2000 and 2001 in part to the new annual EFF filing requirements, which came into effect on January 1, 2000, and to the absolute increase in the number of active corporations. However, since many of the corporations that were presumed to be EFF eligible did not meet all of the requirements for EFF status, they really are in default. As a result, the Ministry's default statistics for 2000 and 2001 correctly include these corporations, and the default statistics for 1999 and earlier years are most likely significantly understated.

Overall, the increases in the number of corporations in default of filing since the time of our last audit are largely attributable to the Ministry's reduced efforts in recent years in following up on overdue returns. Examples of those reduced efforts include the following:

- Default notification letters requesting that outstanding returns be filed have not been regularly sent since 1995.
- The threat to cancel a corporation's charter and seize its assets as a deterrent to chronic non-filers has not been used since 1997.

We also understand that the Ministry's efforts in this area are being hampered by inaccuracies in ITAS; for example, we were advised that the addresses of 71,000 corporations in default of filing returns are currently being traced so that notices requesting the required returns can be issued.

Another means of encouraging a corporation to file an overdue return is to issue it an arbitrary assessment of taxes owing based on the most recently filed return. However, we found that the Ministry seldom uses this measure.

We noted that in February 2001, the Ministry established a unit, presently staffed at 15 employees, but ultimately to be staffed at 30 employees, to follow up on corporations that failed to file a required return. The initial focus of the unit was on corporations that had filed a recent return but had at least one return outstanding for an earlier year. By the end of December 2001, approximately 2,700, or 80%, of the 3,400 corporations that the Ministry followed up on filed the required returns. These returns generated \$2.6 million in self-assessed tax. In addition, 30 corporations were arbitrarily assessed taxes totalling \$130,000. The Ministry advised us that it hopes to collect \$115 million in additional taxes from all corporations in default of filing a required return by the end of the 2003/04 fiscal year.

We estimated that, using the Ministry's current processes, once the unit is fully staffed it will take a significant number of years to follow up on and clear all corporations currently in default of filing a required return.

Recommendation

To help ensure that all required corporations tax returns are received and processed and that the appropriate amount of taxes is collected, the Ministry should:

- **regularly compare the corporations registered in the Ministry of Consumer and Business Services database with those in its own corporations tax database and investigate and resolve discrepancies on a timely basis;**
- **make better use of available tools to enforce compliance by defaulting corporations; and**
- **assess whether additional resources and procedures are warranted to follow up on all outstanding returns and ensure that those returns are appropriately submitted.**

Ministry Response

The Ministry has to date implemented or taken the appropriate steps to initiate the following measures in these areas:

- ***Weekly reports from the Ministry of Consumer and Business Services database will be analyzed in comparison to the corporations tax database.***
- ***Another comprehensive synchronization of the two databases will take place in the fall of 2002.***
- ***Over the past year, the Ministry has applied additional staff and information technology (IT) resources to more effectively follow up on corporations with outstanding returns; the corporations tax database is being matched with federal data to further enhance current risk assessment techniques.***

- *Selective default notices have and continue to be issued for higher-risk corporations tax returns that are overdue.*
- *Charter cancellation will be enforced for non-compliant corporations.*

We will continue to assess whether additional staff and IT resources are required to adequately address the volume of accounts with outstanding tax returns or annual declarations due and to validate their exempt-from-filing status. This would also include reviewing the practice and criteria for selective sending of default notices.

TAX RETURN PROCESSING

The Ministry has an informal guideline in place that requires a submitted tax return to be processed and an assessment to be issued within three to five days of receipt of the return.

We noted that the vast majority of tax returns that are submitted to the Ministry include all of the required information. We found in our review of a sample of such returns that the returns were processed and the assessments were generally issued within three to five days of receipt of the return, as required by the Ministry's guideline.

However, filed tax returns cannot be completely processed in the following circumstances:

- The filed return either lacks required information, or some information provided appears to be questionable and therefore requires verification before the return can be completely processed.
- The taxpayer filing the return is in default of filing a previous year's return.

Returns that cannot be processed are referred to the appropriate unit for follow-up. However, in many cases there was no evidence that the Ministry did follow up on the missing information, and therefore these returns were often not processed on a timely basis. For example:

- As of December 2001, the Ministry held but could not process 8,000 filed returns because the taxpayers were in default of filing a previous year's return. Approximately 10% of these returns had been held for over a year. We were advised that the Ministry had not made any attempts since September 2001 to obtain the missing previous years' tax returns for approximately 6,500 of these returns.
- As of December 2001, the Ministry held approximately 19,000 returns that could not be processed because they lacked some of the required information or because information provided had to be verified. Many of these had been held for an extended period of time—in some cases for over a year and for as long as four years. We found in our review of a sample of these returns that in many cases it was not clear what if anything had been done by staff at the units to which the returns had been assigned to obtain the required information.

In August 2001, the Ministry assigned one person to follow up with the units to which the returns had been assigned.

Recommendation

To ensure that filed returns can be processed and that the correct amount of tax is collected or refunded on a timely basis, the Ministry should follow up on missing information or, when necessary, verify information provided in returns on a timely basis.

Ministry Response

The Ministry has been following up on a monthly basis on the outstanding work items. Steps will be taken to ensure more timely follow-up on information missing from taxpayers' returns, with enhanced tracking and recording of staff efforts in this regard. In addition, we will continue to review and implement additional procedures as required to more effectively manage this process.

MINISTRY AUDIT ACTIVITIES REGARDING TAXPAYERS

The objectives of the Ministry's audit activities regarding taxpayers are:

- to ensure that the corporations selected for audit have declared and remitted the correct amount of tax; and
- through the broader taxpayer population's awareness of the Ministry's audit program, to encourage the broadest possible degree of voluntary compliance.

To achieve these objectives, the Ministry conducts three types of audits:

- *discretionary field audits*—This type of audit is generally limited to corporations reporting over \$7 million in annual gross revenues. Discretionary field audits are conducted at the taxpayer's premises and may include a detailed examination of a corporation's underlying records. For 2000/01, discretionary field audits generated an additional \$225 million in tax assessments.
- *discretionary desk audits*—This type of audit is generally limited to corporations reporting between \$500,000 and \$7 million in annual gross revenues. Discretionary desk audits are primarily conducted in two of the Ministry's regional tax offices and generally include a detailed review of the tax return. In many instances, additional information is requested from the taxpayer by telephone or through correspondence. For 2000/01, discretionary desk audits generated an additional \$9 million in tax assessments.

- *nominal desk audits*—This type of audit is a mandatory review of a corporation's returns that includes: reviews of requests for loss carry-backs (that is, requests to apply losses incurred to retroactively decrease the taxable income the corporation reported in any of the three prior years to allow the corporation to claim a refund of some prior years' tax payments); reviews of requests for refundable Ontario tax credits and amended returns; and the review of federal corporations tax assessments and reassessments for Ontario tax implications. For 2000/01, nominal audits resulted in \$85 million in additional tax assessments and tax reductions totalling \$131 million, most of which were a result of loss carry-backs.

Ontario corporations may also be subject to audit by the CCRA of the federal government. However, except for the sharing of federal corporations tax assessments and reassessments as noted in the bullet above, there have been only limited attempts to co-ordinate audit coverage between the two jurisdictions.

Audit Coverage

To meet its two objectives of ensuring that corporations selected for audit have declared and remitted the correct amount of tax and encouraging broad-based voluntary compliance, the Ministry has established audit coverage goals by type of audit, as shown in the following table.

Planned versus Actual Audit Coverage by Type of Audit, 2000/01

Type of Audit	# of Corporations Eligible for Audit	% of Planned Audits Completed
Discretionary field audit	17,600	94
Discretionary desk audit for corporations reporting \$500,000 and over	79,300	53
Discretionary field audit and discretionary desk audit for corporations reporting less than \$500,000	666,100	n/a*
Nominal desk audit	potentially all 763,000 active corporations	215

* No audits are planned for these corporations, and a minimal number were conducted based primarily on referrals from the audits.

Source of data: Ministry of Finance

As the table indicates, the Ministry completed 94% of the planned number of discretionary field audits of corporations with annual gross revenues of over \$7 million. The largest of these corporations—those with annual gross revenues exceeding \$100 million—have generally been audited on a three- to four-year cycle as planned. We also noted that the

number of discretionary field audits completed has more than doubled since the time of our last audit in 1996, due in part to the doubling of the number of field auditors and increased audit coverage of smaller corporations with annual gross revenues of between \$7 million and \$25 million. The low coverage of these latter corporations was a concern in our 1996 report.

Although the Ministry conducted only about one half of the planned number of discretionary desk audits of corporations reporting annual gross revenues of \$500,000 or more, the number of audits completed still represents a substantial improvement since the time of our last audit in 1996, when only about 200 such audits were completed. No specific number of audits was planned for that year, and the low coverage at that time was primarily due to the fact that most desk auditors were redeployed to the return-processing function at that time.

We also noted that corporations with annual gross revenues of less than \$500,000, which represent about 87% of the total number of corporations on the tax roll, are not normally audited unless specific issues are identified with respect to a particular corporation. This is of particular concern because many of these corporations are owner-managed and therefore may have limited internal controls and financial expertise, which could make them susceptible to compliance deficiencies. In that regard, we noted that, in a study conducted by a professor at a Canadian university of both U.S. and Canadian empirical evidence regarding components of the tax gap, it was found that the percentage of unreported taxes as a function of total tax liability was highest for small corporations. Roughly one half of the amount in unreported taxes was attributable to unreported income and one half to overstated expenses and deductions.

We also noted that a significant proportion of CCRA audits are of smaller corporations, many with revenues of less than \$300,000. We were advised that the Ministry in effect relies on the CCRA to audit these small corporations and has made a deliberate decision that the audit coverage of these corporations should be left to the CCRA. While this would appear to be a reasonable approach to the audit of small corporations, the Ministry did not obtain specific information about the CCRA small-business audit program on which to base such reliance. For example, it did not obtain and monitor information about the CCRA small-business audit such as audit coverage, audit selection criteria, the nature and extent of work performed, and the results obtained.

Recommendation

In order to meet its objectives of ensuring that corporations selected for audit declare and remit the correct amount of tax as well as encouraging broad-based voluntary compliance with the *Ontario Corporations Tax Act*, the Ministry should:

- **conduct the planned number of discretionary desk audits of corporations with annual gross revenues of between \$500,000 and \$7 million; and**

- consider the advisability of auditing, based on assessed risks, more corporations with annual gross revenues of under \$500,000.

Alternatively, if the Ministry continues to rely on Canada Customs and Revenue Agency (CCRA) audits, the Ministry should obtain and monitor specific information about the CCRA small-business audit program so that it can assess whether the program is meeting its expectations and whether the Ministry's reliance on the CCRA audits is justified.

Ministry Response

The Ministry will set realistic targets for the number of discretionary desk audits to be undertaken. We will continue to collect, monitor, and analyze data on the actual number of completed audits against the budgeted figures on a monthly basis and take appropriate action to ensure the planned number of audits are completed.

The Ministry's reliance on CCRA audits of the smallest corporations on the tax roll is intended to achieve efficient use of ministry resources and minimize the compliance burden for these smaller corporations.

However, the Corporations Tax Branch will obtain additional information from the CCRA about its small business audit program to better assess the ongoing effectiveness of this approach and make such changes as are indicated by that review.

Discretionary Field and Desk Audits

AUDIT SELECTION

The process whereby individual corporations are selected for audit is a critical aspect of ensuring that the Ministry's audit function meets its dual objectives efficiently and effectively. Both to ensure that the Ministry obtains the correct amount of tax owing and to encourage broad-based voluntary compliance, it would be expected that the selection process would target those corporations with the highest assessed risks of significant non-compliance and that the selection process would target a sufficiently diverse range of corporations.

We understand that prior to the implementation of ITAS in 1995, the Ministry used to have a system in place that automatically ranked all processed returns using a risk-based point system and made selections from the ranked returns. Such a system is no longer in use. Instead, senior audit managers in each of the four regional offices and in the Corporations Tax Branch randomly select groups of 20 to 50 corporations from a listing of the portion of the tax roll assigned to them. They then conduct a cursory review of the tax returns of each of these corporations and select on the basis of their own judgment 10 to 20 of them for a discretionary field audit.

A similar process is followed for selecting corporations for discretionary desk audit, although the initial random selection is made from a listing of corporations that meet certain criteria (for example, corporations that have claimed eligible investments for capital tax purposes or corporations that are associated with other corporations).

Our concerns with respect to the current selection process are as follows:

- Because the initial selection of 20 to 50 corporations is random, there is no assurance that:
 - those corporations with the highest risks of non-compliance are included in the initial selection and therefore will be considered for selection for audit; and
 - a sufficiently diverse range of corporations, particularly in terms of type of industry and geographic location, is selected to satisfy the ministry objective of encouraging broad-based voluntary compliance (for example, we were advised that some managers limit the number of corporations they select for field audit that have head offices located a long distance from the regional office and thereby minimize travel time and costs).
- The subsequent review of a corporation's tax return is not documented. Also, specific reasons for ultimately selecting a particular corporation for audit are not given, and therefore the basis for selection cannot be determined. Rather, only a general reason for the corporation's referral is provided, such as "provincial allocations," "capital tax," or "general review."
- Some of the senior audit managers we talked to readily acknowledged that, despite their best efforts, many of the selections of corporations they made would not result in a significant reassessment, while, as already mentioned, other corporations with high risks of non-compliance are not necessarily identified. We found that almost one-half of all audits completed during 2000/01 resulted in nil or minimal reassessments of taxes owed.

We were advised that the Ministry was in the process of developing general guidelines for audit managers to consider during the initial file reviews as well as a checklist that would document their file review.

In contrast to the Ministry's informal audit selection process, we noted that, for medium- to large-sized corporations, the CCRA uses a detailed risk-assessment process to assess potential workload. This process includes the use of risk-assessment checklists specific to particular industries and consultations with industry specialists who advise on issues and emerging trends as they arise. This detailed risk assessment is also used to identify specific audit issues and continues throughout the progress of the audit to ensure that only material issues are pursued.

For smaller-sized corporations, the CCRA uses computerized information-matching procedures and applies qualitative and quantitative statistical analyses to identify and select for audit those corporations with a high probability of non-compliance.

We were advised that the Ministry's Tax Revenue Division initiated an Audit Selection Project in July of 2001 that deals with all taxpayer audit activities for all the different types of taxes collected by the Ministry. The objective of the project is to identify and document the current audit selection methods used by branches of the Ministry involved with tax collection and the Ministry's regional tax offices in order to identify best practices and assess the feasibility of centralizing the audit selection function.

Recommendation

To ensure that the Ministry's audit function meets the Ministry's compliance and tax collection objectives efficiently and effectively, the Ministry should ensure that:

- **its audit selection process assesses the risk of significant non-compliance for all corporations and selects those with the highest assessed risk of significant non-compliance; and**
- **it monitors the range of corporations selected for audit to ensure that it is sufficiently diverse in terms of industry type and location to encourage broad-based, voluntary compliance.**

Ministry Response

While the Ministry's current selection process incorporates consideration of risk of non-compliance, we will further investigate the use of a more formalized risk-based approach to further enhance the selection process for both field and desk audits.

The Ministry is also in the process of establishing a new Audit Control and Analysis Unit in the Corporations Tax Branch that will maintain and analyze a database of all assigned and completed audits. The unit will ensure that the range of corporations selected for audit is sufficiently diverse in terms of industry and location.

AUDIT WORK COMPLETED

For auditors conducting discretionary field and desk audits, the Ministry provides an audit manual containing guidelines for audit performance standards that "outline best practices and procedures to assist and direct auditors in fulfilling the requirements of the job." As the manual states, "the guidelines are described in a less structured way so as to provide for individual creativity, flexibility, and use of judgment within the requirements of the position." For example, with respect to audit program preparation, the manual states that the nature and extent of the program to be developed depends on the particular

circumstances of the corporation being audited and then identifies the main factors that influence audit program development.

As a result, in practice, individual auditors have considerable discretion with respect to how the requirements of the guidelines are fulfilled.

We found in our review of a sample of both field and desk audit files completed during the past two years that all proposed audit adjustments arising from areas audited and resultant reassessments issued were correctly determined and supported by the work performed. However, we also noted a number of concerns that ultimately brought into question whether or not all areas where audit work could be justified had been audited and consequently whether or not all taxes properly owing had been assessed and paid. The concerns noted included the following:

- In most instances, we found no evidence that the auditor had assessed all of the areas of potential risk and identified and prioritized the audit work necessary to mitigate the risks. In addition, some significant areas of risk such as transfer pricing or related party transactions were not identified and pursued, since it is the Ministry's view that it is not in a position to do so for several important reasons. For example, the Ministry assumes that it does not have the necessary authority to assess transfer pricing issues because it does not have access to the competent authority process that is only available at the federal and international levels. The Ministry also noted that it cannot possibly dedicate the resources needed to adequately address complex international tax issues. We were advised that, instead, the Ministry relies on the CCRA with respect to the audit of transfer pricing and related party transactions for Ontario-based corporations. However, the Ministry lacked the information about CCRA audits necessary to provide assurance that such reliance was justified.
- Audit file documentation was generally in need of improvement. Most files reviewed did not contain audit programs detailing the nature and extent of the work planned and performed. In approximately one-third of the files we reviewed, we identified at least one issue that should have been pursued but was not, and the reason for not doing so was not documented.
- In most cases, we found little evidence of managerial input during the audit planning stage. Similarly, with respect to the work performed, except for sign-offs on the front of the file, there was often no other evidence of detailed managerial review and approval, such as review notes.

We also noted that, to ensure consistent application of its policies and procedures, the Ministry formed a Quality Review Unit in 1999/2000 to review completed desk and field audit files at all regional tax offices and at the Branch. In the 2000/01 fiscal year, the unit conducted reviews of field audit files at two regional tax offices. The results of those reviews identified similar concerns to ours with respect to audit planning, file documentation, and managerial review.

Recommendation

To ensure that all necessary audit work is completed satisfactorily and that the work performed clearly establishes whether or not taxes owed have been correctly declared, the Ministry should ensure that:

- auditors identify and assess all potential risks of non-compliance by the corporation selected for audit and identify and prioritize all the audit work that needs to be performed;
- where reliance is to be placed on the work performed by the Canada Customs and Revenue Agency (CCRA), it obtains the necessary information about the CCRA audit activities to provide assurance that such reliance is justified;
- auditors use detailed audit programs that clearly indicate the nature and extent of audit work proposed and actually performed; and
- managers adequately document their input at the planning stage of an audit as well as their review and approval of the work performed.

Ministry Response

The Ministry will take appropriate measures to ensure that its current standards are being met consistently in all of the Ministry's office locations where corporations tax audits are undertaken. The Ministry will also review its current field and desk audit standards and make further enhancements to these standards where appropriate.

The Ministry will also examine those areas where reliance is placed on the work of the CCRA, such as international transfer pricing issues, and will consider if there is an ongoing need to obtain more information about the CCRA's audit programs in those areas.

Nominal Desk Audits

Nominal desk audits generally consist of a review of returns that have been amended or contain requests for loss carry-backs or the review of a corporation's federal assessment or reassessment data to determine their effects on provincial tax owed.

Since April 1, 2001, the Ministry of Finance has been receiving daily electronic transmissions of data regarding federal corporations tax assessments and reassessments issued by the CCRA. A provincial corporations tax reassessment, if warranted, must be issued within 365 days of receipt of the federal assessment or reassessment data if a provincial return has been filed for that year and if the return is otherwise already statute barred as defined above in our section on "Tax Return Filing."

However, we understand that there are four circumstances under which a review of federal assessment or reassessment data is not automatically assigned and therefore cannot proceed, as follows:

- The corporation in question does not have a CCRA account number in ITAS.
- The corporation's status in ITAS is inactive.
- The corporation's federal and provincial taxation periods as filed do not coincide.
- The corporation has filed a provincial EFF declaration or is in default of filing the required provincial tax return.

We found that, when any of these circumstances arose, the Ministry was often not timely in investigating the situation and determining whether the appropriate amount of provincial corporations tax had been declared. The result of not reviewing the federal assessment and reassessment data in these circumstances for their effects on provincial tax owed can be that provincial tax is not collected on a timely basis and, as in the case of the 22,000 federal assessments or reassessments discussed below that have not yet been reviewed, that the assessments and reassessments become statute barred and provincial tax revenue is lost. For example, for the period of April 2001 to February 2002, we found the following:

- The Ministry received over 5,300 federal corporations tax assessments or reassessments, representing \$622 million in federal taxable income, for corporations that had filed a provincial EFF declaration or were in default of filing the required provincial tax return. We were subsequently advised that, between the time that we brought these items to the Ministry's attention in February 2002 and June 2002, the Ministry resolved approximately 1,300, or about one-quarter, of these items but assessed no additional provincial tax.
- The Ministry received 41,000 federal assessments or reassessments for corporations that did not have a CCRA account number in ITAS. We noted that, between October 2001 and the end of our audit in June 2002, the Ministry reviewed approximately 17,000 of these assessments or reassessments and identified approximately 600 for potential audit. Of these, 70—with potential recoveries of \$870,000—have been assigned for audit, but the audits have not yet been completed. Unless the remaining 24,000 federal assessments or reassessments are soon reviewed and, where warranted, assigned for audit, they could become statute barred.

Recommendation

To ensure that provincial corporations tax assessments and reassessments resulting from federal assessments or reassessments are issued on a timely basis and do not become statute barred, the Ministry should ensure that it reviews all federal corporations tax assessments and reassessments and completes any required audit work to determine provincial corporations tax applicability on a timely basis.

Ministry Response

Steps are being undertaken to accelerate the review of federal corporations tax assessments and reassessments. Staff recruitment has been initiated in the Desk Audit Section of the Corporations Tax Branch to bring staff back up to the approved complement level. In addition, desk audit staff in the two regional tax offices are assisting with the processing of these adjustment files.

TRAINING NEEDS

In order to keep abreast of the numerous legislative tax changes that occur and be able to adequately audit and assess the reliability of information provided by corporations' increasingly complex accounting systems during tax audits, ministry audit staff need to be properly trained. Training of staff needs to be ministry-wide so that audits are conducted professionally and consistently across the province.

Over the past five years, a great number of auditors were hired for both discretionary desk and field audits. Since the desk audit positions in particular are considered to be entry-level, some of the individuals hired for these positions did not have extensive audit or taxation backgrounds. The Ministry's initial training of auditors consisted of an introductory course that covered the basic requirements of the audit function, the workings of ITAS, and general legislative requirements.

As for ongoing ministry-wide training, we were advised that, in the two-year period of 2000 and 2001, only a total of three days of ministry-wide training was provided. The training covered areas such as legislative changes and the impact of results of tax appeals and taxpayers' objections. Training was not provided in advanced audit and technical legislative requirements.

We found in our visits to several regional tax offices that each office also provides its own on-the-job or informal internal training on issues specific to the office. However, information available was not sufficient to determine the nature and extent of such training provided or to assess its adequacy and effectiveness.

In addition, the field auditors we interviewed informed us that the training received overall was insufficient to provide them with the detailed technical knowledge they would need to conduct comprehensive tax audits specific to particular types of industries. Inadequate training may be one of the reasons why some audit issues were not examined in the files that we reviewed.

In addition to being advised of auditors' concerns regarding the extent of ministry training, we were also advised by many auditors that the Ministry often has not funded training opportunities pursued by individual auditors to increase their tax knowledge base. Such opportunities include membership in the Canadian Tax Foundation and participation in the Canadian Institute of Chartered Accountants' in-depth tax course.

Recommendation

To help enable field and desk auditors to effectively and consistently address corporations tax issues and thereby improve tax collection efforts, the Ministry should:

- ensure that sufficient training that adequately addresses both technically complex issues and industry-specific high-risk areas is provided for both field and desk auditors; and
- consider funding, on an individual basis, training initiatives that would increase the individual auditor's knowledge base.

Ministry Response

The Ministry recognizes the importance of staff training and has recently adopted enhanced training as a strategic priority. To this end, job-specific technical training plans were developed for all audit positions in the division.

A training unit was established earlier this year in the Corporations Tax Branch to enhance current training materials and develop additional technical training materials for both audit and other staff dealing with corporations tax issues in the Branch and in the regional tax offices.

The Ministry will review its current provision of funding for training on an individual basis for auditors and other staff with a view to ensuring training opportunities where they are most required on a priority basis.

TAX ADVISORY SUPPORT

Requests to the Tax Advisory Unit

One of the key responsibilities of the Tax Advisory Unit is to recommend necessary changes to the existing legislation and prepare and communicate, for all units within the Branch, legislative interpretations and rulings for taxpayers. The majority of the interpretation requests come from the field audit area. The requests must be formally directed to the Tax Advisory Unit on a Tax Advisory Enquiry Report form. Upon receipt of these requests, the Tax Advisory Unit records the date the request was received, the nature of the request, the staff assigned to complete the request, and the status of the request. We understand that, during the 2001/02 fiscal year, the Tax Advisory Unit provided 54 advance rulings and 64 written interpretations.

Although, according to the Tax Advisory Unit's senior management, there is no requirement as to how quickly these requests must be completed and returned to the party requesting the information, management believes that it is reasonable for those making a request to expect a resolution within 90 days of the Advisory Unit receiving the request. However,

management staff indicated that, for the past year and a half, most requests have taken from six months to a year to complete.

Our review of the outstanding request log as at March 2002 showed that 25 internal requests remained outstanding, 18 of which were older than 90 days and some of which had been outstanding since November 1998. Management staff at the Tax Advisory Unit informed us that they were aware of the long outstanding requests but were unable to address them due in part to staff vacancies in the area. Some positions had been vacant since late 2000. At the time of our audit, the Tax Advisory Unit was in the process of hiring for these positions.

Communicating the Decisions of the Tax Appeals Branch

Significant decisions made by the Tax Appeals Branch that, for example, result in audit assessment reversals, as well as court decisions regarding audit assessments, are sent to the Tax Advisory Unit. In order for the decisions to assist staff in future audit work and assessments, where warranted, they are to be summarized and communicated to all regional tax offices through channels such as interpretation or information bulletins or through changes to existing policies.

Management staff at the Tax Advisory Unit informed us that they have not formally reviewed and, where warranted, summarized 329 tax appeals decisions made between July 2000 and March 2002. The delay was again due to staff vacancies. At the time of our audit, management staff were in the process of hiring one person to perform the function of reviewing and summarizing the decisions. In the meantime, auditors would not be informed of tax appeals decisions that could impact on their audit approach and their ability to ensure that assessment and appeals decisions are consistently considered in the work the auditors undertake.

Recommendation

To provide good taxpayer service and effectively utilize audit resources, the Tax Advisory Unit of the Corporations Tax Branch of the Ministry should:

- **establish a standard completion time for formal requests for tax advisory services;**
- **address all formal legislative and interpretational requests from regional tax offices within the standard completion time established; and**
- **summarize and, where warranted, communicate all tax appeals decisions to all relevant parties in the appropriate manner and on a timely basis.**

Ministry Response

In November 2001, the Tax Advisory Unit of the Corporations Tax Branch was restructured to improve and enhance the range of services provided. Staffing levels are being increased. The Ministry is also currently consulting with its regional tax offices to develop a reasonable response time for standard tax advisory requests.

The Tax Advisory Unit will expedite the summary and review of significant tax appeals decisions. Corporations tax staff were advised and will be advised on a more timely basis of decisions and tax cases that significantly impact on the Ministry's assessing policies and practices in order to assure timely processing.

THE TAX GAP

As noted previously, one of the Ministry's key objectives is to encourage the highest possible degree of voluntary compliance from taxpayers and thereby reduce the tax gap (the difference between the amount of all taxes actually collected and the amount that should be collected). To know whether this objective is being achieved, the extent of the tax gap must be determined and monitored over a period of time.

The greatest contributor to the tax gap is what is commonly called the "underground economy." The underground economy can be understood to consist of those economic activities that are hidden from public authorities to avoid taxation. While we appreciate that attempts to estimate the size of the underground economy are fraught with difficulties due to differing definitions and assumptions, the latest evidence points to an increasing amount of underground economic activity that is resulting in an increasing tax gap. A research study published in 2002 by the Canadian Tax Foundation found that the underground economy in Canada grew steadily between 1976 and 1995 from about 3.5% to 15.7% of the gross domestic product (GDP). The study estimates that those percentages translate to \$2 billion in missing tax revenue in 1976 and all of \$44 billion in missing revenue in 1995. The underground economy has not only increased in absolute value, but it has grown dramatically relative to the regular economy. The study estimated the value of the underground economy in 2002 at close to 20% of GDP. In 2001, Ontario's GDP represented about 40% of the total Canadian GDP.

In the absence of any ministry assessment and evaluation of the extent to which the tax gap affects provincial corporations tax revenue, it is our view that the tax gap with respect to provincial corporations tax may well be substantial.

Concerns with the growth of the underground economy have prompted the CCRA to launch a number of initiatives. For example, a recent initiative introduced contract reporting, which requires general contractors to report to the CCRA both whom they hired and the amount paid them. In addition, an initiative called the Community Awareness

Program sends a team of auditors into the community to increase taxpayer awareness and to respond to any taxpayer questions or concerns.

The Ministry's Macroeconomic Analysis and Policy Branch is responsible for developing revenue forecasts and estimating potential tax loss attributable to tax evasion. Our discussion with staff from that branch indicated that no studies on the underground economy as it relates to corporations income taxes had been conducted in recent years. However, we believe it is critical for the Ministry to identify any areas of the economy subject to high risk of tax evasion and thus contributing to the tax gap in order to effectively target its resources to minimize corporations tax loss.

Since the Ministry has not assessed the nature and causes of the tax gap, it cannot effectively target its efforts to address the tax gap and assess the effect of its efforts in reducing the tax gap.

Recommendation

To help ensure the achievement of its objective of encouraging the highest possible degree of voluntary compliance from taxpayers and thereby reducing the tax gap, the Ministry should conduct research into the areas contributing to the tax gap and direct the necessary resources to minimize the tax loss.

Ministry Response

The Ministry of Finance has an ongoing program of research related to the tax gap, and staff at the Ministry have contributed to national publications on this subject. Ministry staff closely monitor research undertaken in universities, institutes, and other government agencies in order to apply this information to Ontario's situation. The Ministry will increase its research on factors that could enhance voluntary compliance and address those factors as opportunities are identified.

Two key determinants of a tax gap—the impact of a changing rate of taxation and the level of enforcement activity in a jurisdiction—have been receiving concerted attention.

An additional 170 staff have substantially increased audit coverage, as noted elsewhere in the Provincial Auditor's report. In addition, Ontario's corporate tax rates have fallen dramatically since 1995—the general rate of tax by nearly 20% and the small business tax rate by over 36%.