

Legislative  
Assembly  
of Ontario



Assemblée  
législative  
de l'Ontario

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# STANDING COMMITTEE ON PUBLIC ACCOUNTS

**GASOLINE, DIESEL-FUEL, AND TOBACCO TAX**  
(Section 3.10, 2008 Annual Report of the Auditor General of Ontario)

1<sup>st</sup> Session, 39<sup>th</sup> Parliament  
58 Elizabeth II

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The Honourable Steve Peters, MPP  
Speaker of the Legislative Assembly

Sir,

Your Standing Committee on Public Accounts has the honour to present its Report and commends it to the House.

Norman W. Sterling, MPP  
Chair

Queen's Park  
October 2009

**STANDING COMMITTEE ON PUBLIC ACCOUNTS**

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1<sup>st</sup> Session, 39<sup>th</sup> Parliament

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Research Officer

**STANDING COMMITTEE ON PUBLIC ACCOUNTS**  
**LIST OF CHANGES TO COMMITTEE MEMBERSHIP**

LAURA ALBANESE was replaced by DAVID RAMSAY on September 15, 2009.

ERNIE HARDEMAN was replaced by TED ARNOTT on September 15, 2009.

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## INTRODUCTION

The Ministry of Revenue (Ministry) collected \$4.3 billion in taxes for tobacco, gasoline and diesel fuel in the 2007/08 fiscal year. That constituted about 6.2% of Ontario's total taxation revenue from all sources. However, the tax gap, which is the difference between the amount of tax that should be collected and the amount of tax that is actually collected, with respect to tobacco tax has grown significantly in recent years.

It is the Auditor General's (Auditor's) view that the tobacco tax gap could be in the range of \$500-million for the 2006/07 fiscal year based on tobacco tax-rate increases and estimated consumption in recent years. This was one of several key findings of the Auditor's value-for-money audit report of gasoline, diesel-fuel and tobacco tax (section 3.10 of the Auditor's *2008 Annual Report*).

In February 2009 the Standing Committee on Public Accounts held public hearings on this audit report. Senior officials of the Ministry appeared before the Committee. (For a transcript of our proceedings, see Committee *Hansard*, February 25, 2009.) Our report highlights the Auditor's observations and recommendations and presents our own findings, views, and recommendations. We request that the Ministry provide the Committee Clerk with a written response to each recommendation within 120 calendar days of the tabling of this report with the Speaker of the Legislative Assembly, unless otherwise specified in a recommendation.

We endorse the Auditor's findings and recommendations. We would also like to thank the Auditor and his team for drawing attention to these important taxation issues.

## OVERVIEW

The Auditor noted in his audit that many of the changes suggested in his earlier 2001 audit on commodity taxes have still not been implemented. The Auditor believes that the Ministry's current policies, procedures and information technology systems are still inadequate to ensure that the correct amount of tobacco, gasoline and diesel taxes is being declared and paid in accordance with the law. During the hearings we questioned the Ministry on a number of related topics including the following:

- smuggling and sale of illegal tobacco products;
- relations with the Canadian Border Services Agency, the RCMP and the OPP;
- purchases of tax free cigarettes on First Nations reserves;
- accounting for tobacco, gasoline and diesel-products; and
- planned system modifications to ensure completeness and accuracy of tobacco, gasoline and diesel tax returns.

The tax rate on cigarettes and cut tobacco, in particular, has increased dramatically since 1999 as illustrated in figure 1 below.

<b>Effective Date</b>	<b>Tobacco Tax Rate</b>
November 6, 1999	2.65
April 6, 2001	3.65
August 1, 2001	3.65
November 2, 2001	4.45
June 18, 2002	8.60
November 25, 2003	9.85
May 19, 2004	11.10
January 19, 2005	11.725
February 1, 2006	12.35

Source of data: Ministry of Revenue

## **OBJECTIVES AND SCOPE OF THE AUDIT**

The objective of the audit was to assess whether the Ministry had adequate and cost-effective policies and procedures in place to ensure that the correct amount of tobacco, gasoline, and diesel-fuel tax is collected and paid to the province in accordance with the law.

## **ISSUES RAISED IN THE AUDIT AND BEFORE THE COMMITTEE**

Significant issues were raised by the audit and before the Committee. We attach particular importance to twelve of these issues, discussed below.

### **Tobacco Tax Gap**

As noted earlier, the Auditor believes that the potential tobacco tax gap for the 2006/07 fiscal year could be in the \$500 million range. He recommended that the Ministry should assess its policy options for mitigating the incentives for the smuggling and sale of illegal tobacco. These options could include increased sanctions for non-compliance with provisions of the *Tobacco Tax Act*, and more targeted enforcement.

During our public hearings we heard from the Ministry that it is difficult to define the tobacco tax gap with certainty as information, estimates and assumptions all affect the calculation. The Ministry said that it cannot confirm the \$500 million figure because there is no verifiable data, but the Ministry acknowledged that there are tax losses arising from the sale of illegal tobacco products and that this is a serious concern.



## Committee Recommendation

The Standing Committee on Public Accounts recommends that:

- 1. The Ministry of Revenue shall provide the Standing Committee on Public Accounts with its estimate of the tobacco tax gap and shall advise the Committee of the underlying rationale and assumptions used in determining its estimate.**

### Border Security and Control of the Illegal Tobacco Trade

This is a joint responsibility of the Canadian Border Services Agency (CBSA), the RCMP, and the OPP, in conjunction with the Ministry's Special Investigations Branch (SIB). The Auditor noted that all organizations acknowledged having resource and other limitations including, for example, the fact that convictions under the provincial *Tobacco Tax Act* do not result in a criminal record. The Auditor estimated that less than 5% of the potential illegal cigarette trade was seized in 2007. He recommended that the Ministry should consult and work more closely with the CBSA, 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.

The Ministry told us that it recognizes the importance of working with federal and provincial enforcement agencies on this issue. The Ministry's SIB recently created an intelligence unit, which will facilitate greater coordination of joint projects with existing partners and better outreach capability. The Ministry discussed several related issues, noted below.

#### *SIB*

At present, two thirds of the SIB, which is the smallest branch in the Ministry, is working on tobacco investigations. The SIB has spent a great deal of time developing and nurturing partnerships with a number of agencies. Since 2001 partnerships among enforcement agencies have been the key to success. SIB staff members are not police officers, but still contribute to investigations. The SIB's intelligence assessment unit includes ex-police officers from Durham Regional Police. The unit focuses on the contraband tobacco distribution chain. An average seizure for the SIB is about 1,000 cartons.

#### *Partners' Jurisdiction*

The Ministry said that the majority of contraband tobacco entering Ontario comes from the United States, most enters around Cornwall. Contraband tobacco comes across the St. Lawrence River in the summertime and across ice bridges in the winter. This means that it is necessary to police a continuous border, not just border entry points. Five jurisdictions operate in the Cornwall area – New York state, Ontario, Quebec, the Canadian federal government and the US federal government. The Ministry works with multi-jurisdictional partners. This raises issues related to enforcement and the existence of numerous strategies to deal with contraband tobacco.

There are seven integrated border enforcement teams (IBETs) in Ontario. Although none of the SIB officers is posted in the Cornwall area, the SIB regularly partners with the Cornwall-Valleyfield IBET. The lead agency is the RCMP. It has jurisdiction when contraband cigarettes cross the border. Other IBET participants are the CBSA, municipal police services, provincial government agencies and United States agencies.

### Supplementary Information

The Auditor subsequently informed the Committee that all of the SIB staff is posted in Oshawa.

Some cigarette factories on the American side of the border may or may not be legal from an American perspective. The Ministry believes that the New York state government and the US federal authorities are trying to deal with this issue. Tobacco that crosses the border into Canada without paid excise tax or Ontario tobacco tax is illegal.

The RCMP enforces excise legislation. Charges under the federal *Excise Act* are not criminal charges (as is also the case with charges under the *Tobacco Tax Act*). The SIB prosecutes tobacco tax offences. Cases vary; some might result in both federal and provincial charges; others will not. In certain situations the RCMP will operate under the *Criminal Code* but generally prosecutes under the *Excise Act*.

### Committee Recommendation

The Standing Committee on Public Accounts recommends that:

- 2. The Ministry of Revenue's Special Investigations Branch (SIB) should consider posting SIB staff in areas of key contraband activity in Ontario, such as the Cornwall region. The Ministry shall report to the Standing Committee on Public Accounts on any benefits or drawbacks associated with posting SIB staff in these areas and on any decisions reached on this matter.**

The Ministry said that the *Tobacco Tax Act* is a very strong piece of legislation. There are jail penalties under the Act and the Ministry is increasingly trying to seek these penalties. In other words, if someone is caught with a large enough amount of contraband tobacco, this could result in a jail sentence. The Ministry said that the issue of contraband tobacco is a worldwide problem. It believes, for example, that in the UK approximately one third of all cigarettes are illegal.

### Supplementary Information

The Ministry of Revenue provided information in Figure 2 below, on the number of *Tobacco Tax Act* cases put forward for prosecution resulting from a partnership with the OPP.

<b>Figure 2: The Number of Tobacco Tax Act Cases Put Forward for Prosecution Resulting from Partnership with the OPP</b>			
Fiscal Year	OPP	SIB & others	Total
2004-05	1	24	25
2005-06	3	39	42
2006-07	4	60	64
2007-08	79	51	130
2008-09 (to Dec 31/08)	104	71	175

- A Special Investigations Branch (SIB) partnership with the OPP increased significantly in the 2007-08 fiscal year.
- The OPP partnership is centred primarily in the Cornwall area and cases prosecuted primarily result from routine *Highway Traffic Act*, or RIDE program stops.
- The partnership consumes a significant part of SIB's tobacco investigation resources.
- As of December 31, 2008, the SIB had sent a total of 212 cases to the Legal Services Branch recommending prosecution (175 are tobacco-related which accounts for just over 80 per cent of total prosecution recommendations).

The Ministry of Revenue provided additional information regarding its partnership with the OPP. Figure 3 below lists the number of contraband tobacco seizures; figure 4 lists the quantity of cigarettes seized.

<b>Figure 3: The Number of Contraband Tobacco Seizures</b>			
Fiscal Year	OPP	SIB & others	Total
2004-05	0	36	36
2005-06	8	58	66
2006-07	5	46	51
2007-08	96	72	168
2008-09 (to Dec 31/08)	121	59	180

<b>Figure 4: Quantity of Cigarettes Seized</b>			
Fiscal Year	OPP	SIB & others	Total
2004-05	0	10,965,000	10,965,000
2005-06	2,399,395	2,748,075	5,147,470
2006-07	519,800	4,919,000	5,438,800
2007-08	21,700,120	3,615,480	25,315,600

2008-09 (to Dec 31/08)	23,829,020	9,513,060	33,342,080
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- Most of the 2007-08 and 2008-09 OPP-related seizures and quantity of cigarettes seized are in the Cornwall area and are the result of stops made to enforce *Highway Traffic Act* offences or RIDE-related stops.
- As 2007-08 and 2008-09 seizures and resultant cigarettes seized indicate, the SIB is investing significant resources in that area of the province, and standalone SIB investigations or partnerships with other agencies are significantly lower than in 2006-07 and prior years.

### *Seizures, Fines and Court Rulings*

The Ministry provided data on cigarette seizures. Over the past five years 80 million cigarettes have been seized (60 million of these were seized in the past three years). As of February 2009, 33 million cigarettes had been seized in the 2008/09 fiscal year. About 175 cases were referred to the legal services branch for prosecution, resulting in 131 convictions. The Ministry also seized 12 million grams of fine-cut tobacco (this is tobacco used by people who roll their own cigarettes) and 78,000 cigars.

In fiscal year 2007/08, 25 million cigarettes were seized, 130 cases were referred to the legal services branch resulting in 55 convictions. Courts imposed just over \$2 million in fines for those convictions. The Ministry said that court rulings now increasingly include probation, community service and jail time.

Many seizures during the 2008/09 fiscal year have occurred with the support of the OPP on routine traffic-related stops. The OPP does not have legislative authority to seize tobacco. If a police officer stops a driver on a *Highway Traffic Act* offence and notices contraband tobacco, the officer will call the Ministry and the Ministry will authorize the OPP to seize the tobacco. The Ministry will then collect the tobacco. At times, the OPP may phone the RCMP instead of the Ministry. The RCMP would seize the vehicle, take it to lock-up and likely lay excise charges. The Ministry may still want to also lay tobacco tax charges (e.g. generally possession of unmarked tobacco). In such situations, the Ministry will then prosecute its case. Fines are determined in court.

We asked whether it would be helpful if charges were laid under the *Provincial Offences Act*, so the OPP would be responsible for enforcement instead of the Ministry. The Ministry replied that it is unable to direct the affairs of the OPP, which decides where to focus its resources based on intelligence and risk analysis. However, the Ministry said that it is considering ways to make the partnership with the OPP through IBET (which has been very successful) more responsive. The Ministry said there could be improvements to give the OPP a bigger role in the Cornwall area. The Ministry is examining options.

## Supplementary Information

The Ministry of Revenue provided additional information on the sentencing results from successful *Tobacco Tax Act* prosecutions in figure 5 below.

Fiscal Year	Number of convictions	\$ value of fines (approximate)	Other sentences
2004-05	16	N/A	-
2005-06	22	N/A	-
2006-07	29	\$1.2 million	-
2007-08	55	\$2.1 million	Jail terms: 2 Probation: 2
2008-09 (to Dec 31/08)	131	\$3.9 million	Jail terms: 10 Probation: 19 Community Service: 12

- Courts are looking less at imposing large fines and are increasingly including community service, probation and jail terms in their sentencing.
- The SIB is responsible for carriage of the above noted cases including inventorying of tobacco seized, gathering supporting evidence, laying the charges, and appearing as Crown witnesses. The Ministry's Legal Services Branch provides the prosecutors on all these cases.

The Ministry also drew attention to new measures to encourage tobacco tax compliance that are contained in the 2009 Ontario budget. The proposed measures would add the following:

- enforcement provisions aimed at individuals suspected of contravening the act;
- the authority for the court to suspend the driver's licence of a person convicted of an offence under the act involving the use of a vehicle;
- provisions that prohibit the possession of any quantity of unmarked cigarettes, unless otherwise permitted under the act; and
- requirements to mark fine-cut tobacco similar to cigarettes. Revenue officials will consult with manufacturers on how to best implement this measure.

## Committee Recommendations

The Standing Committee on Public Accounts recommends that:

3. **The Ministry of Revenue shall provide the Standing Committee on Public Accounts with an update on the Ministry's review of its relationship with police forces, specifically commenting on whether or not the Ministry of Revenue and the Ministry of Community Safety and Correctional Services plan to propose legislative amendments to**

**enable police forces to seize contraband tobacco that they find, without requiring permission from the Ministry of Revenue to do so.**

- 4. The Ministry of Revenue shall report to the Standing Committee on Public Accounts on whether, in the Ministry's opinion, contraband tobacco smuggling has increased or decreased in the last few years. If, in the Ministry's opinion, tobacco smuggling has increased, the Ministry should advise the Committee on what new initiatives it has recently undertaken, or is planning to undertake, to combat such smuggling.**

### *Cigarette Making Machinery*

We also asked whether there was a licensing provision for cigarette production that would facilitate provincial control of production. The Ministry replied that the *Budget Measures and Interim Appropriation Act*, which received Royal Assent in November 2008, included a manufacturer registration requirement for purchasers and importers of cigarette-making machinery. This includes penalties and sanctions if registration is not provided and strengthened seizure and forfeiture provisions.

### **Tobacco Allocation System on First Nations Reserves**

Ontario allows First Nations people to buy specified amounts of tax-free tobacco products on reserves for their personal use. A number of manufacturers/wholesalers with operations on reserves sell cigarettes to reserves significantly over and above the bands' existing allocations. The Auditor concluded that some of these cigarettes were undoubtedly destined for sale to non-band members.

The Auditor recommended that the Ministry 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.

During the hearings the Ministry said there is a need to continue to work with First Nations leaders to ensure that the tobacco allocation system is respected. First Nations leadership will be critical on this issue. The Ministry said that it relies on the role of the Ministry of Aboriginal Affairs in fostering good relations with aboriginal leaders.

The Ministry recognizes that there are limitations to the province's ability to enforce provincial tobacco tax laws on First Nations reserves. Both the *Tobacco Tax Act* and the *Excise Tax Act* have jurisdiction on-reserve. The Ministry faces some jurisdictional issues regarding seizure and judgments on reserves under section 89 of the *Indian Act*. The Ministry believes that it has jurisdiction on tobacco issues and could seize tobacco on-reserve. However, the Ministry does

face jurisdictional limitations in connection with the personal property of a First Nations individual on-reserve.

Recent amendments to the *Tobacco Tax Act* permit the exchange of information with other governments and municipalities and their agencies, boards and commissions where the information is used to monitor the manufacture, distribution, export, import, storage, sale or advertisement for sale of tobacco. This will help facilitate greater coordination and effectiveness among the levels of government.

### Committee Recommendation

The Standing Committee on Public Accounts recommends that:

- 5. The Ministry of Revenue shall report to the Standing Committee on Public Accounts on its initiatives, or initiatives undertaken in conjunction with partners such as the Ministry of Aboriginal Affairs, to engage First Nations leadership on the issue of ensuring that the tobacco allocation system is respected on reserves.**

### Cigar Taxes

Ontario, Nunavut and Yukon are the only jurisdictions in Canada that do not limit sales of untaxed cigars on First Nations reserves. The Auditor and the Ministry both believe that the tax foregone on cigar sales to and from reserves is significant. The Auditor recommended that the Ministry should develop and implement an allocation system for cigars similar to that for cigarettes and ensure that it is adhered to.

During the hearings the Ministry noted that implementation of an allocation system for cigars would require a regulatory change. The Ministry said that it is reviewing options in the context of the government's focus on fostering its new relationship with the aboriginal communities. One option would be to consider whether the current cigarette allocation system, which is a formula-based system, is appropriate for cigars. The Ministry needs to determine the options, the correct timing, and consider political sensitivities with aboriginal leaders. The deputy minister said the Ministry's current focus is on contraband tobacco. She believes this is a pressing problem relative to the cigar allocation system.

### Supplementary Information

The Ministry provided the Standing Committee on Public Accounts with supplementary information on cigar options, indicating that the Ministry does have specific proposals. The Ministry said that it is consulting with key stakeholders as part of its analysis.

### Committee Recommendation

The Standing Committee on Public Accounts recommends that:

- 6. The Ministry of Revenue shall provide the Standing Committee on Public Accounts with a status report on the Ministry's consideration of whether or not it will introduce an allocation system for cigars similar to that in place for cigarettes. Given that almost all other provinces have a cigar allocation system, if the Ministry will not be introducing this, the Ministry shall provide its rationale to the Committee.**

### Cigarette Production and Control

There are three large recognized manufacturers of Canadian-branded cigarettes that either manufacture cigarettes in Ontario or import them into the province. Cigarettes manufactured for taxable consumption are marked with yellow tear-tape in the wrap of each package. The Auditor noted that for a variety of reasons, monthly information received by the Ministry on tear-tape purchase, consumption and sales data has been of little value. The Auditor made recommendations for improving the information, including increasing detail and reconciling the information received to assess the reasonableness of the reported use of yellow tear-tape in relation to reported taxable sales, if the Ministry decides to continue to use the tape.

During the hearings the Ministry said that among amendments adopted in 2004 to the *Tobacco Tax Act* and its regulations were enhanced registration and reporting requirements for cigarette manufacturers and for manufacturers of tear tape. The Ministry has registered three tear tape manufacturers and receives monthly production and sales information from them on total tear tape material. The Ministry is examining the ability to reconcile this information with the number of packages of cigarettes manufactured and marked with the yellow tear tape. The reconciliation of tear tape purchase and use will be done during audits on cigarette manufacturers beginning in fiscal year 2009-10.

The Ministry told us that the Canada Revenue Agency (CRA) has been developing a proposal since 2005 to replace the yellow tear-tape with a stamp (similar in appearance to a postage stamp) that has both overt and covert security features. These security features, which would be difficult to replicate, would be intended to better identify fully tax-paid cigarettes versus illegal, potentially counterfeit cigarettes. The Ministry believes that the stamp would cost a bit more than the yellow tear-tape.

The CRA hopes to be able to introduce the stamp in 2010, though the initiative is at the consultation stage only. It has not yet been determined which provinces would be willing to participate. Yellow tear-tape is subject to counterfeit. However, the Ministry said that counterfeit cigarettes presently constitute only a small portion of the cigarette market. The stamp would not address the issue of contraband cigarettes coming across the border in bags, for example. For these



reasons, as well as cost concerns, a Ministry representative believes that industry representatives are sceptical of the initiative.

### **Gasoline- Diesel- and Tobacco-tax Return Processing**

The Auditor noted that there was little evidence the Ministry attempted to verify completeness and accuracy of the tax returns. Many tobacco-tax returns in the Auditor's sample were incomplete. The Ministry manually reviews and processes the returns. The Auditor questioned whether the Ministry has adequate staff and resources to conduct the process effectively. The Ministry had developed a detailed checklist for processing gasoline and diesel-tax returns since the last audit; however, the checklist was not being used.

The Auditor's recommendations relate to ensuring that all returns and relevant schedules are received and assessed for completeness and accuracy, that there is follow-up to questionable items, and in the case of gasoline and diesel-tax returns; that the Ministry expedite its planned implementation of a computerized tax-return processing function.

During the hearings the Ministry said that since the 2001 audit it has enhanced registration and reporting requirements for manufacturers and introduced regulation and reporting requirements for transporters of tobacco products, as well as refiners and transporters of fuel and gasoline products. It has also reviewed filing procedures and staff access to file storage areas to ensure that hard copies of returns are retained as required. Where necessary, Ministry employees follow up with the registrant to obtain missing schedules information. (See also discussion on Ontario's Tax Services ONT-TAXS below.)

### **Gasoline and Diesel Taxes**

Tax rates have not increased since the last audit, but revenue has. Tax exempt diesel is dyed; taxable fuel is clear. The Ministry designates as collectors of gasoline and diesel taxes all refiners and wholesalers who in the previous year sold not less than 51% of their product by volume at wholesale.

In the hearings the Ministry explained that off-road, unlicensed vehicles are allowed to use coloured diesel. This would include those types of vehicles used, for example, in production facilities, farming and fishing. Recreational vehicles may not use coloured diesel.

### **Gasoline Tax Exemptions**

Under the *Gasoline Tax Act*, First Nations people who hold a valid Ontario-based Certificate of Exemption may purchase tax-exempt gasoline on a reserve for personal use. For each tax-exempt sale, the retailer completes a Ministry-issued voucher providing detailed information on the transaction. (The Auditor found questionable items in a sample of vouchers reviewed.) In most cases, the retailer pays the gasoline tax on purchasing inventory, and then submits a tax refund

request to the Ministry. Certificates of Exemption are issued by the province and never expire.

The Auditor noted that controls over the issuance of the certificates are lax. The Auditor recommended that the Ministry should exercise more vigilance in its review of refund vouchers, including appropriate follow-up when necessary, and strengthen its procedures for the issuance and cancellation of Certificates of Exemptions.

During the hearings we heard that the gasoline exemption program for First Nations individuals has been in place for a number of years. Initially the cards were plastic, with embossed numbers. The cards, which are still Ontario-based cards, now have electronic swipe mechanisms.

The federal government, through Indian and Northern Affairs Canada (INAC), is now examining the possibility of adding electronic components – either a chip or a stripe – to individual status cards. The Ministry said this would be a more secure form of identification and of determining exemption because a First Nations individual would be unlikely to lend a status card to someone else. The Ministry said that it will be able to partner with the federal government when it is ready to launch the new card, to further streamline the provision of statutory refunds to First Nations retailers.

In September 2008 the Ministry began phasing in an electronic filing system for refunds. The Ministry said that this shift from a manual processing system to an automated one will enhance the Ministry's ability to validate claims and identify questionable claims. Gasoline retailers who use the electronic system receive their refunds in a matter of days, instead of weeks.

The electronic service is a voluntary service. It came into effect in September 2008 after four years of consultations with First Nations leaders. The leaders requested a system that was voluntary, flexible, fair and transparent. Currently about four retailers have signed up and are using the service. Nearly two dozen more are in the process of moving towards using the system. The Ministry believes the system is working well.

We asked for clarification on whether or not natural gas is taxed when used as a vehicle propellant. The Ministry said that natural gas, when used as a vehicle fuel, is exempt from gasoline tax.

## **Gasoline, Diesel and Tobacco Tax Audits**

### *Audit Coverage*

There is no tax-revenue threshold for registrants for the purpose of setting audit coverage goals. The Auditor indicated that the Ministry is falling short of its goal of auditing the largest and riskiest collectors on a four-year cycle.

### *Audit Working-paper Files*

The Auditor expressed concern that several of these files that were requested could not be located. Those that were reviewed lacked evidence of managerial review and approval. The Auditor noted cases where auditors were told by managers to terminate the audit and issue a nil assessment without documenting in the file the reason for doing so.

The Auditor recommended that the Ministry complete audits of the largest and higher-risk designated collectors within the planned four-year periods and that it ensure that all working-paper files are retained and clearly document the work done and decisions made. The Auditor also said the Ministry should require supervisory review, approval and documentation of decisions in key phases of the audit work.

The Ministry told us that it does use a risk-based audit selection system. Risk profiles for motor fuels and tobacco tax accounts have been defined to support audit selection. The Ministry's tax compliance branch created a training unit to support ongoing improvement. Training for all audit staff has been held. As well, each audit file includes a management involvement form that documents all the discussions and decisions between the auditor and the audit manager.

The Ministry said that its new ONT-TAXS system has potential audit functions. The "collectors" or "wholesalers" that collect tobacco, fuel and gasoline tax for the Ministry provide a significant amount of information on schedules with their returns. The Ministry intends to have that information either imaged or data-captured in a specific area to facilitate more proactive analysis of the data. This would be useful for audit and administrative enforcement. (See below for further discussion of ONT-TAXS.)

## **Field Inspections**

### *Gasoline and Diesel Inspections*

The seven field inspectors primarily conduct random roadside audits to ensure that tax-exempt dyed diesel is not used in vehicles driven on provincial roads and highways (fuel terminals etc. are considered to be low risk). In cases of violations, inspectors issue a Provincial Offences summons and may also issue a tax assessment. The Auditor noted that there was no evidence that the Ministry assessed the risk and extent of various tax-evasion schemes. The Auditor questioned whether inspectors were being deployed in the most effective manner.

For example, the Auditor noted that for the 2006/07 fiscal year, the Ministry's seven gasoline and diesel inspectors issued just 24 assessments, with a total value of \$42,000. In the 2007/08 fiscal year, the same seven inspectors issued 38 assessments worth \$152,640. This compares to the similarly modest results at the time of our last audit in 2001, when 12 inspectors issued assessments totalling \$260,000 in the 2000/01 fiscal year.

The Auditor recommended that the Ministry formally assess the likely risk and extent of the use of untaxed fuel in vehicles operating on provincial roads and highways and develop an inspection strategy tailored to the risk. The Ministry should assess the results of improving its enforcement efforts before concluding that more inspectors are needed.

During the hearings the Ministry said that in cases where an individual is suspected of having put coloured diesel in a vehicle not allowed to use coloured diesel, inspectors will take more than one dip sample from the fuel tank in order to be able to preserve a sample in case it is required in court. If the individual is deemed to have committed an offence, a Provincial Offences ticket is issued. The provincial charge is a set fine collected through the court system of \$430, plus a mandatory victim surcharge of \$75. The vehicle is not seized. (A Ministry representative said that he believes that after three tickets, there will be a referral to the SIB, which then pursues the matter through the court.)

If it appears that the individual is operating a business, the Ministry will examine fuel use over a period of time. For example, in a business with a fleet of 50 vehicles, the Ministry will look for the tax-paid, non-coloured fuel. If it cannot be proven that tax-paid fuel has been used in a licensed vehicle, the Ministry will raise a tax assessment for the amount of consumption, based on the mileage of the vehicle and the length of vehicle ownership. This means there would be a provincial charge plus a potential tax assessment.

The Ministry said that work plans are reviewed on an ongoing basis as fuel prices fluctuate and risks increase or decrease. During the 2008/09 fiscal year, the frequency of inspections of terminal and bulk plants was reduced in recognition of the level of tax compliance in this area. The emphasis shifted to coloured-fuel checks of vehicles, large consumers of diesel fuel and wholesalers because of the risk that with the rise in the price of fuel, there might be an increase in attempts to use coloured fuel to save the cost of the tax.

There is a risk that vehicles meant for forestry or farming operations are being driven on licensed roads. The Ministry conducts joint blitz work with the OPP and the Ministry of Transportation on the 401 series of highways, when vehicles are stopped for safety issues. The Ministry said that it agrees with the Auditor's comments regarding risk assessment.

### **Tobacco Retail Inspection Program**

The program, initiated in 2006, had 33 inspectors at the time of the audit. The number of inspectors has since increased to 58. The Auditor noted that Ministry records indicated that in 2007/08 inspectors seized approximately 3,500 cartons of cigarettes and issued assessments worth a total of about \$3.1 million. This accounts for a small percentage of the overall estimated annual tax gap. The Auditor wondered whether a better return might result from devoting some of these resources to other areas. The Auditor recommended that the Ministry assess whether the expansion of the program was 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.

### *Inspection Procedures*

During the hearings the Ministry said it believes that the physical presence of Ministry staff in communities across the province, combined with inspections of tobacco retail locations, is an effective tool in limiting the number of illegal cigarettes available to consumers through the retail network. This province-wide program results in the inspection of tobacco inventories and business records of tobacco retailers. During any routine retail inspection, inspectors also provide information, including printed materials, to tobacco retailers to educate and advise them of their responsibilities related to the sale of tobacco products.

Inspections are unannounced. Inspectors are uniformed and are often accompanied by an audit staff member who will examine the books and records. This usually occurs in cases of insufficient records to support tobacco products on the shelves. The purpose is to determine whether the Ontario tobacco tax has been paid on products through a reconciliation of the records. If contraband tobacco is found, the inspector provides the retailer with a preliminary assessment in writing, on the spot. The retailer has a 30-day period to provide further information. The final assessment is subject to the standard objection and appeal process under the *Tobacco Tax Act*. The Ministry works with other agencies to help the inspection staff be able to identify contraband tobacco.

### *Smoke-Free Ontario*

The Ministry said the *Smoke-Free Ontario Act* incorporates some of the strongest tobacco control legislation in North America and that the Ministry complements this strategy through its inspection efforts targeted at tobacco retailers and through its partnerships with law enforcement agencies. Ministry inspectors will work with the Ministry of Health Promotion and municipal health units to conduct joint inspections, for example, on issues related to selling to minors.

### *Number of Inspections*

Since the inception of the tobacco retail inspection program in 2006, the number of tobacco tax inspectors has nearly doubled and there now is an average of about 600 retail inspections every month. There are approximately 15,000 to 20,000 convenience stores and tobacco stores in Ontario. The number of retail outlets for cigarettes can be higher (in the 20,000 range) because venues such as bowling alleys sell cigarettes. Now that the Ministry has more inspectors it anticipates that the monthly inspection figure will increase.

### *Penalties Assessed*

Ministry data available in February 2009 indicated that since July 2006 the program had assessed penalties of \$9 million and confiscated about six million cigarettes. (During fiscal years 2007/08-2008/09 the program assessed penalties

of \$7.9 million and confiscated about 828,000 cigarettes.) The Ministry has collected over half of the \$9 million assessed.

The Ministry referred to the increased penalties and seizure provisions in the *Budget Measures and Interim Appropriation Act*. Before these provisions were enacted, a retailer found with just one carton of illegal cigarettes would have received a penalty of \$74.10. Today, that penalty is \$574.10. On a second occurrence, the minimum penalty is \$2,500 and on a third occurrence, it is \$5,000.

In 2007, a number of legislative amendments were introduced to the *Tobacco Tax Act*. Significant among these were provisions which authorize the Ministry to prohibit (temporarily) a retail location from selling, offering for sale and storing any tobacco if it is found to have repeatedly contravened the *Tobacco Tax Act* or sections of the *Smoke-Free Ontario Act*. At the time of the hearing the Ministry had issued one prohibition notice.

#### *Cost of Program*

The Ministry has projected program costs with 58 inspectors. Based on historical data and assuming that the amounts assessed will remain approximately the same (the Ministry noted that there has been a decrease in assessments) there will be a return of approximately \$2.25 for every dollar spent on the program. The Ministry said that the amount assessed will be slightly higher than the amount collected. The Ministry calculated the return on investment, based on the amount assessed.

The Ministry said that part of the value of the program is awareness of the program and maintaining the inspectors' presence in the marketplace to discourage contraband tobacco sales through retail outlets. There is a cost associated with this. The Ministry is assessing amounts that it anticipates the province will follow through on for collection or potential write off.

#### **Committee Recommendation**

The Standing Committee on Public Accounts recommends that:

- 7. The Ministry shall report to the Standing Committee on Public Accounts on the total amount of penalties assessed under the *Tobacco Tax Act* between July 2006 and the end of fiscal year 2008/09, how much of this was collected, and how much was written off. The Ministry should also report on whether it will publish the information on its website.**

#### *Increase in Level of Compliance*

As the inspection program has progressed, the Ministry has noticed a higher level of compliance in the retail community. The Ministry now finds 50% less contraband tobacco than was initially the case. It said that it must monitor where contraband tobacco networks may move next.

### **Committee Recommendation**

The Standing Committee on Public Accounts recommends that:

- 8. Given the increase in compliance levels with respect to sales of contraband tobacco in the retail community, the Ministry of Revenue shall report to the Standing Committee on Public Accounts on the results of Ministry efforts to monitor the emergence or expansion of other networks for the sale of contraband tobacco and on any proposed new Ministry strategies to address this.**

#### *Inspections at Point of Manufacture*

The Ministry said that its inspections at manufacturing locations are limited. Most manufacturers do not sell directly (to individuals). They sell product to a wholesaler, who acts as a Ministry tax collector. The Ministry does conduct some inspection work at manufacturing sites but not to the same degree as at retail sites.

#### *Tobacco-growing Industry*

According to the Ministry, one stipulation under consideration is for tobacco producers, as part of a licensing regime, to have a licensed buyer. This might introduce an element of control within the system in that licensed buyers such as major manufacturers would have a vested interest in ensuring that the amount of illicit tobacco growth is minimized.

### **Committee Recommendation**

The standing Committee on Public Accounts recommends that:

- 9. The Ministry of Revenue shall report back to the Standing Committee on Public Accounts on the introduction of a new licensing system for tobacco leaf production, noting in particular how the new licensing system will help minimize the growth of illicit tobacco.**

### **Business Process Re-engineering**

The Auditor believes that the current process of requiring collectors to file monthly paper returns rather than electronic filing is impractical. In the 2001 audit, in response to the Auditor's recommendation, the Ministry said that it was introducing a business process re-engineering project that would include such features as electronic filing of all returns as well as data comparison features to facilitate analysis. That project has since been replaced by the ONT-TAXS accounting system for commodity tax programs. The system is in a planning stage. The Auditor encouraged the Ministry to invest the necessary resources in planning and up-front design to ensure appropriate functionality and to research systems in other jurisdictions.

### *MOST and ONT-TAXS*

The Ministry said it is improving its business processes through the Modernizing Ontario's System for Tax Administration (MOST) project. MOST, launched in 2004, was mandated to replace 65 older tax administration systems with ONT-TAXS, which is one integrated system.

The base product for ONT-TAXS is a commercial off-the-shelf system. It has proven successful in two other provinces (British Columbia and Manitoba) and 16 US jurisdictions. Trinidad and Tobago also uses it; Vietnam is studying Ontario's implementation of the system. ONT-TAXS will provide service enhancements for tax clients, including online tax services, facilitating both electronic filing and electronic payment. The system will also allow a company or business to be identified by a single business number and will constantly be upgraded. The Ministry will accrue administrative savings. For example, it will be able to eliminate numerous multiple registrations, resulting in the maintenance of fewer accounts.

The Ministry said that once commodity taxes are transitioned from the STARPAC legacy system to ONT-TAXS, all information from the tobacco tax returns/schedules will be captured and retained, the reported information will be assessed for completeness, any incomplete or missing documents will be identified, and follow-up correspondence and exception reports will be generated for investigation by staff as required. The development work is underway now. The plan is to transition tobacco, gasoline and diesel tax returns to the ONT-TAXS system in fall 2009.

Before the system goes live for all businesses and tax types, the Ministry is testing it to ensure that all appropriate safeguards are in place and to tailor the system to meet the needs of Ontario clients. The Ministry has already introduced ONT-TAXS to retail sales tax and employer health tax clients and introduced new online functions which allow tax clients to authorize their employees or tax representatives to conduct business with the Ministry on their behalf.

When developing ONT-TAXS, the Ministry set up an advisory group to provide it with feedback and suggestions on the types of services and tools that would best meet client needs. The Ministry is striving for a tax administration system that is efficient, fair, and flexible, supports compliance and reduces the burden on business. The Ministry said that it is delivering the ONT-TAXS system on time and on budget. It expects the system to be fully implemented by March 2010.



### Supplementary Information

The Ministry of Revenue provided the following figures regarding the uptake of the ONT-TAXS system:

ONT-TAXS online take up statistics as of March 31, 2009:

Sign ups – 3,746  
Payments – 1,353 (\$2,274,463)  
Returns – 2,123

Electronic services – year to date as of March 31, 2009:

Returns – 8.6% of returns have been filed electronically  
Payments – 21.77% of payments have been remitted electronically  
Payments dollars – 29.95% of payment dollars have been remitted electronically

### Committee Recommendation

The Standing Committee on Public Accounts recommends that:

- 10. By March 2010, the Ministry of Revenue shall provide a status report to the Standing Committee on Public Accounts on the implementation of the Ontario Tax Services (ONT-TAXS) system for tobacco, gasoline and diesel tax returns. The Ministry should note any strengths or limitations of the system regarding electronic filing of returns, electronic payments, and data capture features to facilitate data analysis and the generation of exception reports.**

**LIST OF RECOMMENDATIONS**

- 1. The Ministry of Revenue shall provide the Standing Committee on Public Accounts with its estimate of the tobacco tax gap and shall advise the Committee of the underlying rationale and assumptions used in determining its estimate.**
- 2. The Ministry of Revenue's Special Investigations Branch (SIB) should consider posting SIB staff in areas of key contraband activity in Ontario, such as the Cornwall region. The Ministry shall report to the Standing Committee on Public Accounts on any benefits or drawbacks associated with posting SIB staff in these areas and on any decisions reached on this matter.**
- 3. The Ministry of Revenue shall provide the Standing Committee on Public Accounts with an update on the Ministry's review of its relationship with police forces, specifically commenting on whether or not the Ministry of Revenue and the Ministry of Community Safety and Correctional Services plan to propose legislative amendments to enable police forces to seize contraband tobacco that they find, without requiring permission from the Ministry of Revenue to do so.**
- 4. The Ministry of Revenue shall report to the Standing Committee on Public Accounts on whether, in the Ministry's opinion, contraband tobacco smuggling has increased or decreased in the last few years. If, in the Ministry's opinion, tobacco smuggling has increased, the Ministry should advise the Committee on what new initiatives it has recently undertaken, or is planning to undertake, to combat such smuggling.**
- 5. The Ministry of Revenue shall report to the Standing Committee on Public Accounts on its initiatives, or initiatives undertaken in conjunction with partners such as the Ministry of Aboriginal Affairs, to engage First Nations leadership on the issue of ensuring that the tobacco allocation system is respected on reserves.**
- 6. The Ministry of Revenue shall provide the Standing Committee on Public Accounts with a status report on the Ministry's consideration of whether or not it will introduce an allocation system for cigars similar to that in place for cigarettes. Given that almost all other provinces have a cigar allocation system, if the Ministry will not be introducing this, the Ministry shall provide its rationale to the Committee.**
- 7. The Ministry shall report to the Standing Committee on Public Accounts on the total amount of penalties assessed under the Tobacco Tax Act between July 2006 and the end of fiscal year 2008/09, how**

**much of this was collected, and how much was written off. The Ministry should also report on whether it will publish the information on its website.**

- 8. Given the increase in compliance levels with respect to sales of contraband tobacco in the retail community, the Ministry of Revenue shall report to the Standing Committee on Public Accounts on the results of Ministry efforts to monitor the emergence or expansion of other networks for the sale of contraband tobacco and on any proposed new Ministry strategies to address this.**
- 9. The Ministry of Revenue shall report back to the Standing Committee on Public Accounts on the introduction of a new licensing system for tobacco leaf production, noting in particular how the new licensing system will help minimize the growth of illicit tobacco.**
- 10. By March 2010, the Ministry of Revenue shall provide a status report to the Standing Committee on Public Accounts on the implementation of the Ontario Tax Services (ONT-TAXS) system for tobacco, gasoline and diesel tax returns. The Ministry should note any strengths or limitations of the system regarding electronic filing of returns, electronic payments, and data capture features to facilitate data analysis and the generation of exception reports.**