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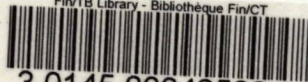
Jewellery Tax Evaluation Report

June 1993

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Jewellery Tax Evaluation Report

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Introduction

The excise tax on jewellery is applied under the *Excise Tax Act* to items commonly or commercially known as jewellery, including diamonds and other precious or semi-precious stones. The tax is also applied to clocks and watches for personal use valued at more than \$50. The tax is levied at a rate of 10 per cent on the manufacturer's sale price for jewellery produced in Canada and on the duty-paid value of imported jewellery. For the 1991-92 fiscal year, total revenue from the tax amounted to \$48 million. About \$14 million of these revenues came from imported jewellery.

The Canadian Jewellers Association (CJA) and other jewellery manufacturers have raised a number of concerns about the current excise tax on jewellery. In particular, they claim that the tax acts as an incentive to black market activities in jewellery, is complex and involves substantial costs of administration. In response, the government agreed to undertake a formal review of the jewellery tax.

To provide background information for the review, the government commissioned a study by the consulting firm of Ernst and Young. The background study, which is entitled *Jewellery Excise Tax Study*, examined the nature of the jewellery industry and investigated whether the excise tax contributed to black market activities. It also examined the likely impact on government revenues of eliminating the excise tax.

This evaluation report draws heavily from the information provided by the background study¹. Specifically, it focuses on three main areas:

- the structure of the jewellery tax;
- estimates of jewellery sales escaping the tax through illicit activities and other methods; and
- the costs of administering and complying with the tax.

Background

■ *History of the excise tax on jewellery*²

The excise tax on jewellery dates back to 1918. It was introduced as part of an extensive package of excises on items that were considered to be luxury or non-necessary goods. The new taxes were to raise revenues needed to contain the deficits incurred and expected to continue as a result of the First World War. The levies were anticipated to fall on those who could most afford to contribute to the deficit control and reduction efforts.

¹ Wherever the evaluation report makes specific reference to information initially presented in the background study, page references are provided. Copies of the background study are available from the Department of Finance Distribution Centre, 140 O'Connor St., Ottawa K1A 0G5. Tel: (613) 995-2855, Fax: (613) 996-0518.

² Revenue Canada, Customs and Excise, *A History of Federal Sales and Excise Taxes*, October 1973.

Subsequently, the luxury excises underwent a number of changes in design including changes in tax base, rate and trade level at which the taxes were applied. For the most part, the changes were associated with wartime financial needs and efforts to reduce postwar deficits and debt. For example, between 1942 and 1949, jewellery and other selected products were taxed at the retail level at 25 per cent. In 1949, the jewellery tax was moved back to the manufacturer's level and the rate reduced to 10 per cent. During the Korean conflict, the tax rate was raised first to 15 per cent and then to 25 per cent in 1951. In 1952, the rate was reduced to 15 per cent. Finally, in 1954, the tax rate was set at its current level of 10 per cent. When the government replaced the manufacturer's sales tax with the GST, the jewellery tax was retained for revenue purposes and continues to be levied at the manufacturer's level.

■ *The jewellery industry*³

Consumer expenditures on jewellery and watches were about \$2.1 billion in 1991. Diamond jewellery is the main product, accounting for about 50 per cent of sales in 1992. Precious metal jewellery accounts for about 15 per cent of sales, and coloured stone jewellery for 10 per cent. The remaining sales include clocks and watches (10 per cent), fashion jewellery (6 per cent) and pearls (3 per cent). All diamonds and most other jewellery inputs are imported. However, a substantial amount of gold jewellery is fabricated domestically.

Over the years, the structure of the jewellery industry has been shifting towards small scale operations. Currently, about 75 per cent of manufacturers have fewer than 10 employees. These operations account for about 20 per cent of industry output. Approximately 55 per cent of industry output is produced by firms with 10 to 99 employees, while the remaining 25 per cent is produced by firms with 100 or more employees.

Perhaps the most important development during the past decade has been the emergence of small manufacturers known as "micro-manufacturers". A number of factors have contributed to this trend. For example, small manufacturers can produce sophisticated products using modern digital equipment costing \$10,000.

Other structural changes have also occurred in the jewellery industry. During the 1960s and 1970s, the industry relied on traditional distribution channels. Importers and foreign suppliers sold to manufacturers, manufacturers sold to wholesalers, and wholesalers sold to retailers. With increased competition from new retail formats (such as catalogue stores, home shopping networks and retailer/manufacturers), the jewellery industry is becoming more integrated and traditional channels are being bypassed. For example, manufacturers are now importing finished goods and selling these items along with their own products directly to consumers. Retailers are bypassing importers and wholesalers, and buying directly from foreign suppliers.

³ Ernst and Young, *Jewellery Excise Tax Study*, 1993, pp. 4-19.

Finally, there is an increasing number of custom manufacturers. These operations are usually small manufacturers that take jewellery parts and materials supplied by a retailer or wholesaler, manufacture the finished product and then deliver the product back to the retailer or wholesaler.

Basic Structure and Administration of the Excise Tax

The excise tax on jewellery functions in the same manner as the now-defunct federal sales tax (FST). It is payable by manufacturers on the sale price of taxable items manufactured in Canada and by importers on the duty-paid value of taxable imports.

Taxable items include unset diamonds, precious stones or semi-precious stones, finished jewellery, articles made in whole or in part from ivory, jade or other precious stones, as well as clocks and watches for personal use. This means that importers are liable for tax on imports of unset gems as well as on finished pieces of jewellery, unless the application of the tax is delayed by other provisions of the *Excise Tax Act* as discussed below. On the other hand, precious metals are not taxable unless they are formed into jewellery. Therefore, precious metals can be imported without being taxed, provided they are not yet jewellery.

The licensing system for the excise tax is also the same as for the FST. In general, the excise tax functions through the licensing of manufacturers of taxable products. Under the *Excise Tax Act*, a manufacturer is required to apply for a licence at the point where sales in a calendar year exceed \$50,000. From that point on, the manufacturer is licensed and must pay the tax on all taxable sales. A manufacturer can apply to be delicensed if annual sales can be shown to be below \$50,000. Under the licensed wholesaler provisions, a licensed wholesaler can import taxable items free of the excise tax and account for the tax at the time of sale. In 1991, there were 1,206 jewellery licensees.

As with the FST, the administration of the jewellery tax includes an administrative system that permits manufacturers to account for the tax on the basis of "established" or "determined" values, rather than on the sale price. This administrative system was developed to provide for equitable treatment in sectors with various distribution channels. In the absence of these administrative measures, manufacturers with an in-house distribution system would be disadvantaged because the sale price of their goods (which is also the base for tax) would include marketing and distribution costs. Using determined values, however, manufacturers selling to consumers may discount the sale price by a certain amount before applying the 10-per-cent tax. For example, the authorized discount is 50 per cent in the case of jewellery priced below \$2,000 and sold directly to consumers.

In the case of clocks and watches, the first \$50 of duty-paid value or manufactured value is exempt from the excise tax. For other items subject to the excise tax, there is an administrative rule which exempts items with a value of less than \$3. This rule also applies to gems and jewellery entering Canada at less than \$3 in duty-paid value.

Jewellery Sales Escaping the Excise Tax

In considering jewellery sales by commercial enterprises that escape the jewellery tax through illicit activities and other methods, the following three categories provide a useful framework.⁴

- i) **Tax avoidance at the manufacturer's level:** Tax avoidance refers to legal methods by which taxpayers structure their affairs to reduce or eliminate the amount of tax payable. In the case of the jewellery tax, examples of avoidance include the use of multiple corporate structures to qualify manufacturing activities for the small manufacturer's exemption. In the present analysis, sales of jewellery are placed in the category of "tax avoidance at the manufacturer's level" when three conditions are met:
 - gems and other inputs have been recorded by official sources, such as the information collected by Statistics Canada on imports reported at the border;
 - no excise tax has been paid at the manufacturer's level, although income tax may have been paid; and
 - other taxes, such as the GST and income tax, have been paid on the final retail sale.
- ii) **Tax evasion at the manufacturer's level:** Tax evasion refers to the use of illicit means to minimize the amount of tax payable. In the case of the jewellery tax, examples of tax evasion include failing to report some manufacturing activity or using smuggled diamonds. Sales of jewellery are placed in the category of "tax evasion at the manufacturer's level" when three conditions are met:
 - gems and other inputs have *not* been recorded by official sources, such as Statistics Canada;
 - no excise tax has been paid at the manufacturer's level, although income tax may have been paid; and
 - other taxes, such as the GST and income tax, have been paid on the final retail sale.
- iii) **The underground economy:** This category refers to illicit activities that appear to be part of a chain of activities resulting in non-compliance with various taxes, one of which is the excise tax on jewellery. In the case of the jewellery industry, an example would be unreported cash sales of jewellery made from smuggled diamonds. Unreported sales of jewellery in "the underground economy" are, therefore, characterized by three conditions:
 - inputs have *not* been recorded by official sources, such as Statistics Canada;
 - no excise tax has been paid at the manufacturer's level and, presumably, no income tax has been paid; and
 - other taxes, such as the GST and income tax, have *not* been paid on the final retail sale.

⁴ Ernst and Young, *Jewellery Excise Tax Study*, 1993, p. 31.

In general, this framework illustrates the distinction between legal and illicit methods of escaping the excise tax on jewellery. While tax avoidance reduces revenues from the tax, it is not illegal under the current legislative provisions. In practice, of course, it can be difficult to draw clear lines between cases of tax avoidance and cases of tax evasion because there are ways to combine methods of avoidance and evasion to escape the tax. This framework also illustrates the distinction between illicit activities involving only the excise tax on jewellery and illicit activities involving a wider range of taxes.

■ ***Examples of methods being used to escape the tax***

Some methods of escaping the excise tax on jewellery are related to factors other than the tax. For example, jewellery is recognized as a traditional area of smuggling activity around the world. Illegal channels of trade operate on a global basis. A large part of smuggling is in diamonds where illicit gems can undercut regular market pricing. Also, diamond smuggling is considered to be relatively easy to carry out because of the small size and high value of these items. Since diamond jewellery accounts for about half of the jewellery sales in Canada, a certain amount of underground activity may be expected to occur up to the retail level irrespective of the amount of tax applied to these items.

At the same time, interviews with members of the jewellery industry have identified a number of weaknesses in the operation of the excise tax on jewellery. In particular, several structural or administrative features of the excise tax appear to make it prone to tax avoidance. These features of the tax also appear to be involved in certain forms of tax evasion, particularly when they are combined with the use of smuggled gems.⁵

Small manufacturer's threshold

In the case of domestically manufactured jewellery, unlicensed manufacturers are a primary source of unreported sales. Unlicensed manufacturers are permitted to operate under the small manufacturer's threshold. By virtue of this threshold, manufacturers that do not exceed \$50,000 in sales per calendar year do not have to register or pay the excise tax on jewellery. However, these manufacturers are required to apply for a licence and account for the tax once sales exceed the \$50,000 threshold for the first time.

The small manufacturer's threshold becomes a source of tax avoidance when it becomes a part of tax planning. As a single stage tax applied at the manufacturer's level, the jewellery tax is collectible only at the point where manufacturing occurs. If production and marketing structures can be organized so that this point is considered to occur in a business that can qualify for the small manufacturer's exemption, then the amount of tax payable can be eliminated or reduced to the tax paid on gems and stones. For example, a business might use a multiple corporate structure to qualify some manufacturing activity for the small manufacturer's exemption.

⁵ Ernst and Young, 1993, *Jewellery Excise Tax Study*, pp. 24-30 and pp. 51-53.

Discussions with members of the jewellery industry indicate that the small manufacturer's threshold is also being used in combination with other methods of tax avoidance or tax evasion to market jewellery without payment of the excise tax. A manufacturer can evade tax, for example, by combining the small manufacturer's threshold with the use of smuggled gems. Since gems are taxable, legitimate gems would generally be acquired by an unlicensed manufacturer on a tax-paid basis. If an unlicensed manufacturer uses smuggled gems, however, no excise tax would be paid on either the gems or the sale of the final product by the manufacturer.

Unlicensed manufacturers can also occur if manufacturers are unaware of their responsibilities under the *Excise Tax Act*. In this regard, interviews with members of the jewellery industry indicate considerable confusion in the industry regarding the rules for becoming licensed for the tax. For example, a small firm might not recognize some of its activities as manufacturing and, therefore, fail to register as required. While being unaware of responsibilities under the Act is a form of non-compliance, it can be considered to be distinct from the planned tax avoidance and tax evasion discussed above.

Lack of associated corporations rule

There is no associated corporations rule for the jewellery excise tax. Therefore, firms can avoid the jewellery tax by creating associated corporations to multiply their eligibility for the small manufacturer's exemption. Firms can also separate out specific activities that might otherwise fall within the tax base if included in the main company, such as marketing and distribution costs. Although the operation of several corporations involves additional costs and complexities, interviews with industry participants indicated numerous examples of manufacturers reorganizing their companies in order to reduce excise tax that would otherwise be payable.

Administrative threshold for inexpensive jewellery

The administrative threshold of \$3 also creates opportunities for tax avoidance. The threshold applies on a piece-by-piece basis. Therefore, a piece of jewellery can enter Canada in unassembled components with no tax being paid on gems, stones and other components that are valued under the \$3 threshold.

The administrative threshold can also be combined with the small manufacturer's threshold to further avoid the jewellery tax. For example, an unlicensed manufacturer can obtain tax-free inputs by importing gems below the \$3 threshold. If these tax-free gems are also made into jewellery by an unlicensed manufacturer, then the final product would also escape the excise tax.

Provisions for custom manufacturing

The custom manufacturing provisions also appear to be involved in tax avoidance and tax evasion, including the use of smuggled gems. These provisions are described briefly below, along with some examples of avoidance and evasion.

When an unlicensed person (often a wholesaler or retailer eligible for the small manufacturer's exemption) owns gems or other jewellery inputs, and supplies these inputs to a manufacturer to produce a finished product under a custom manufacturing contract, the manufacturer is considered to have sold the finished product to that person for the cost of the labour under the contract. That is, the manufacturer operating under the custom manufacturing contract is considered to have provided manufacturing services without taking possession of the inputs supplied by the unlicensed person. Accordingly, the excise tax is applied only to the labour costs under the contract. Regarding the gems and stones, the excise tax would have been applied at an earlier time, such as the time of importation, as long as the unlicensed person is supplying legitimate gems or stones under the contract.

The provisions for custom manufacturing can be involved in either tax avoidance or tax evasion, depending on the circumstances. Cases of tax avoidance involve using these provisions in tax planning to minimize the amount of tax legally payable in respect of the final product. One example of tax avoidance would be combining custom manufacturing with the use of the administrative threshold for inexpensive jewellery and the small manufacturer's exemption. As noted above, inputs under the \$3 threshold are tax-free. If these tax-free inputs are supplied under a custom contract, then tax on the final product would be limited to only the tax payable on the labour costs. Even this amount of tax can be avoided if the manufacturer providing the labour under the contract is an unlicensed manufacturer.

If smuggled gems are supplied under a custom contract, then the provisions for custom manufacturing become involved in tax evasion. In this case, the smuggled gems would be untaxed and the final product would bear only the tax on the labour costs under the custom contract.

■ *Estimates of jewellery sales escaping the excise tax⁶*

Clearly, it is very difficult to estimate the extent of manufacturer's avoidance, manufacturer's evasion and the underground economy in jewellery. Using various sources of available information and interviews with a cross-section of the jewellery industry, however, the estimates presented in Table 1 have been derived for 1990 (Annex I provides a more detailed description of how these estimates were generated). The estimates for the underground economy rely primarily on comments from the industry. Using this information, total sales (measured at the retail level) that appear to have escaped the jewellery tax are estimated to range from \$945 million to \$1,402 million. These estimates exclude clocks and watches.

⁶ Ernst and Young, *Jewellery Excise Tax Study*, 1993, pp. 43-46.

Table 1
Estimates of sales escaping the jewellery tax in 1990

Category	Amount of retail sales
	(millions of dollars)
Manufacturer's avoidance	488
Manufacturer's evasion	276
The underground economy	181 – 638
Total	945 – 1,402

To put these estimates in context, commercial sales of jewellery in Canada were about \$1.8 billion in 1990.⁷ Of course, the \$1.8 billion in commercial sales does not include any of the \$181 million to \$638 million in sales estimated to have occurred in the underground economy.

In producing the above estimate of manufacturer's avoidance, it has not been possible to distinguish between cases of tax planning and cases where compliance simply results in no tax being paid. For example, the estimate includes sales by manufacturers that are small enough to qualify for the small manufacturer's threshold without any tax planning. It should also be noted that the above estimate of manufacturer's avoidance would include firms operating a legitimate business, but genuinely unaware of an obligation to become licensed and to account for the excise tax in respect of their manufacturing activities.

■ *The incremental effect of the jewellery tax on tax evasion and the underground economy*

The excise tax is one of a number of taxes providing margins for illicit activities in Canada. However, the amount of the excise tax tends to be small relative to other taxes. A diamond solitaire ring, for example, selling for \$6,090 at the retail level in Ontario would include \$240 in excise tax, \$354 in GST and \$404 in Ontario provincial sales tax (PST). The retail price would also include \$36 in additional GST and PST because the excise tax is included in these tax bases. In this example, the excise tax (i.e., \$240 plus \$36) accounts for about 27 per cent of the total federal and provincial tax margins, or about 4.5 per cent of the final price. For items with higher retail markups, such as gold chains, the excise tax accounts for a smaller share of the total amount of tax.

The available evidence also suggests that jewellery industry compliance practices may not be very responsive to changes in tax margins. The introduction of the GST provides a recent example of this. When the FST was in effect, many of the methods of

⁷ According to Statistics Canada data, total consumer expenditures on watches and jewellery in 1990 were about \$2.257 billion. The estimate of \$1.8 billion in commercial sales of jewellery is derived by subtracting provincial sales taxes, estimated clock and watch sales, and estimated direct imports of jewellery by consumers.

avoidance/evasion could reduce or eliminate both the 10-per-cent excise tax and the 13.5-per-cent FST (for a combined tax rate of 23.5 per cent at the manufacturer's level). When the FST was replaced by the GST on January 1, 1991, tax at the manufacturer's level dropped to 10 per cent because jewellery producers became eligible for input tax credits in respect of GST paid on inputs. Although this drop in tax would be expected to have reduced avoidance/evasion activities, there is as yet no evidence that this is happening.⁸

Two further issues are whether the excise tax encourages cross-border shopping and whether it encourages Canadian consumers to smuggle American jewellery into Canada. While there are no statistics on either cross-border shopping or smuggling by Canadian consumers, members of the jewellery industry have suggested that cross-border shopping reduces Canadian jewellery sales by 10 per cent to 15 per cent.

However, a comparison of the pricing structures for various items of jewellery sold in Canada and in the U.S. indicates that the excise tax is only one of several factors accounting for price differences in the two countries. This can be illustrated by the following examples.⁹

A diamond solitaire ring purchased in the U.S.

Recent information indicates that the retail price of a diamond solitaire ring sold in Canada is estimated to be about \$6,090 in Canadian dollars. A similar ring sold through similar retail channels in the U.S. is estimated to cost about \$5,125 in Canadian dollars. About 29 per cent of the initial price difference is attributable to the excise tax, 25 per cent is due to higher retail margins in Canada, and the remaining 46 per cent occurs because the GST and provincial sales taxes exceed the state and local taxes on jewellery in the U.S.

If the ring were to be declared at the border, the consumer would pay 2.6-per-cent duty, 10-per-cent excise tax and 7-per-cent GST, all on the purchase price. This would raise the full price of the American ring to about \$6,190. A resident of Quebec would pay another 8 per cent at the border for provincial sales tax.

A 10K gold chain purchased in the U.S.

In the case of an 18-inch, 10K gold chain, the estimated retail price is \$72 in Canada and \$53 in the U.S., in Canadian dollars. The excise tax accounts for about 11 per cent of the initial price differential. In this case, about 13 per cent of the price difference is due to higher labour costs at the manufacturing level, 45 per cent is due to higher retail markups and the remaining 31 per cent occurs because the GST and provincial sales taxes are higher than the American state and local taxes on jewellery.

If the gold chain were to be declared at the border, duty, excise tax and GST would raise the final price of the chain to \$69. For a Quebec resident, the final price would be \$74.

⁸ Ernst and Young, *Jewellery Excise Tax Study*, 1993, p. 27.

⁹ Ernst and Young, *Jewellery Excise Tax Study*, pp. 59-63.

These two examples indicate that the excise tax may be an incentive for consumers deciding to shop in the U.S. and smuggle their purchases into Canada. However, the tax is only one of a number of factors accounting for lower jewellery prices in the U.S. Furthermore, the excise tax is not a dominant factor in the initial price difference between items purchased in the U.S. and those purchased in Canada. Regarding the issue of smuggling, the excise tax is only one of the taxes and duties applied at the border when purchases exceed a person's travel exemption. The largest effect of the excise tax may occur in the case of diamond rings and other high-price items that are made in the U.S. (where duties are being phased out) and brought into provinces that do not have provincial sales tax collected at the border.

In the broader context, jewellery appears to be a regular target for smuggling and other underground activities around the world. Given an ongoing access to illicit gems and finished jewellery, buyers and sellers may be expected to engage in a certain amount of underground activity regardless of tax margins.

Overall, the above evidence indicates that the jewellery excise tax is not a dominant factor in the underground economy for jewellery. Certainly, eliminating the excise tax would remove one of the margins of those involved in illicit activities. However, as noted above, the excise tax accounts for only about 4.5 per cent of the final price of a diamond solitaire ring selling for \$6,090 at the retail level. Removing this amount of tax is unlikely to produce a major reduction in the underground economy. Other factors in domestic and international markets for gems and jewellery can be expected to continue to attract buyers and sellers to illicit activities.

■ *Potential for revenues*¹⁰

When considering the potential for revenues, it is useful to distinguish between retaining the jewellery tax and eliminating the tax.

Retaining the jewellery tax

The jewellery excise tax currently raises government revenues of about \$50 million per year. If steps were taken to address tax avoidance by eliminating all exemptions, as much as \$488 million in retail sales could be brought into the tax base. Applying the excise tax to these sales at the manufacturer's level is estimated to raise another \$17 million, for total revenues of about \$67 million per year. However, the actual increase in government revenues is likely to be less than \$17 million as long as some small manufacturers are permitted to be exempt from the tax.

¹⁰ Ernst and Young, *Jewellery Excise Tax Study*, 1993, pp. 65-67.

Eliminating the jewellery tax

Eliminating the jewellery tax would reduce current excise tax revenues by about \$50 million per year. However, this revenue loss could be offset by increased GST and income tax revenues if the removal of the tax were to result in a large shift of jewellery sales from the underground economy into the legitimate market. These incremental revenues could occur because GST and income tax are not being paid in the case of final products sold in the underground economy. In the case of sales classified as manufacturer's avoidance and manufacturer's evasion, however, it appears that GST and income tax are being paid.

When members of the jewellery industry were asked to estimate the additional sales that might result from the elimination of the excise tax, the general answer was 30 per cent to 60 per cent. These estimates also correspond to their estimate of the illicit market for jewellery. In effect, this would imply that eliminating the excise tax would entirely eliminate illicit sales. After accounting for manufacturer's evasion, these estimates imply that retail sales captured from the underground economy would be in the range from \$181 million to \$638 million.

If the elimination of the excise tax did draw \$638 million in retail sales from the underground economy into the legitimate market, these sales would increase GST revenues by an estimated \$45 million. There would also be an increase in income tax revenues of \$10 million. In the event that total revenues of \$55 million were generated in this way, they would offset current revenues from the jewellery tax. However, even revenues of this magnitude are likely to fall below the revenues that might be raised if the excise tax was modified to bring tax avoidance activities into the excise tax base,

In the event that legitimate retail sales increased by only \$181 million, GST revenues would increase by about \$13 million and income tax revenues by \$2.5 million – for a total of only \$15.5 million.

In deciding whether a final estimate is more likely to be at the high or the low end of this range, other factors need to be considered. In particular, a high estimate is not consistent with available evidence suggesting that there is a relatively weak connection between the excise tax and illicit activities in the jewellery industry. As illustrated by the example of the solitaire ring, the excise tax represents only about 27 per cent of the taxes payable on this type of ring in Ontario, and about 4.5 per cent of the retail price. This weak relationship suggests that the elimination of the excise tax is unlikely to capture much of the underground economy. As a result, any offsetting revenues from other taxes are likely to fall short of the revenues that would be lost by eliminating the jewellery tax.

Overall, the elimination of the excise tax would likely lead to some additional revenues from the GST and income tax, but these revenues are likely to be quite modest. There are two main reasons for this conclusion. First, GST and income tax appear to be paid on jewellery sales that are categorized as manufacturer's avoidance or manufacturer's evasion. Second, even if the excise tax is eliminated, there would continue to be a significant overall incentive to deal in the underground economy and evade other taxes, and the industry practices necessary to do so are well entrenched.

Administration and Compliance Costs of the Tax

The CJA estimated that the cost of collecting the jewellery tax was about \$38 million in 1990. This estimate assumed that the costs of administering the tax accounted for about 20 per cent of the RCMP sales and excise tax budget, and 5 per cent of the Customs budget for border and airport services. This estimate appears to be much too high for a number of reasons. In particular, the costs of administering the excise tax should be considered in terms of incremental costs. That is, costs over and above the costs incurred for the purposes of other taxes, because the costs associated with other taxes would be incurred with or without the excise tax.

At present, jewellery entering the country must be evaluated for duty and GST purposes. The only costs that would disappear with the elimination of the excise tax are those of identifying the goods as jewellery subject to the excise tax and adding the 10-per-cent levy to other taxes and duties assessed at the border. Similarly, since a suspected smuggler will likely be charged with evading duties and the GST as well as the excise tax, enforcement and prosecution costs for the excise tax do not represent an additional cost to the government. For these reasons, incremental administrative costs related to border valuation and enforcement of the jewellery tax are minimal.

The costs of collecting and accounting for the tax from domestic manufacturers are approximately \$60,000 per year. Audit costs add another \$175,000, for total collection and audit costs of approximately \$235,000.¹¹

All told, the incremental cost to the government of collecting the jewellery excise tax almost certainly does not exceed 1 per cent of collections. This is broadly in line with estimates of collection costs for taxes of this type. Studies in other countries have also shown that collection costs for this type of tax typically fall in the range between 1 and 2 per cent of collected revenues.¹²

In the case of the jewellery industry, compliance costs for large manufacturers are insignificant because these firms generally have sophisticated, computerized accounting systems that calculate the excise tax automatically. In small firms, however, there may not be computerized accounting systems or inventory control methods to support the tracking of the tax. Small operations have indicated that tracking the tax manually is onerous. However, precise estimates of compliance costs for the excise tax and how these costs compare with the compliance costs of other taxes are not available.

¹¹ Estimate provided by Revenue Canada.

¹² See e.g., Arthur Anderson & Co., "The Administration and Compliance Costs of the Federal Sales Tax System with a Brief Comparison to the Retail Sales Tax System of Ontario", paper prepared for the Department of Finance, 1987, Chapter 1; C. Sandford, "The Administrative and Compliance Costs of the United Kingdom's Value-Added Tax", *Canadian Tax Journal*, 1990, pp. 1-20.

Conclusions

There appears to be considerable potential for avoiding and evading the excise tax on jewellery through the use of certain features of the tax, such as the small manufacturer's threshold, the administrative threshold and the custom manufacturing provisions. In the case of tax evasion, however, it is difficult to determine how much is excise tax induced and how much is due to other factors, such as worldwide smuggling networks. In this regard, the available evidence indicates that the excise tax accounts for a relatively small part of the margins captured by persons engaged in illicit activities. Also, the available evidence indicates that reducing tax margins does not appear to have much of an effect on bringing illicit activities into the legitimate market for jewellery.

Regarding cross-border shopping and smuggling, the analysis shows that the excise tax is unlikely to be a major factor in these activities. While the excise tax is one of the factors contributing to price differentials between jewellery purchased in Canada and the U.S., the taxes and duties applied to jewellery declared at the border tend to reduce but in most cases not eliminate the initial price gap. For Canadian consumers choosing to smuggle U.S. jewellery into Canada, the other taxes and duties would continue to provide margins for smuggling even if the excise tax was eliminated.

In the case of administration and compliance costs, the excise tax involves some incremental costs but these do not appear to be substantial. Incremental administration costs for the government are unlikely to exceed 1 per cent of the collected revenues. Incremental compliance costs appear to be insignificant for large manufacturers. While compliance costs may be more of a burden for some small manufacturers, no precise estimates are available.

The analysis also shows that eliminating the tax is likely to result in a net loss in revenues to the government. Although there may be some increased revenues collected by the GST and income tax, these gains are not likely to be sufficient to offset the full amount of revenues from the excise tax.

At the same time, the analysis has identified a number of weaknesses in the operation of the excise tax. In general, the basic structure of the levy has many of the problems of the FST because the tax is applied to the sale price at the manufacturer's level. Also, the tax has a number of features that appear to make it prone to tax avoidance and evasion.

First, there is the small manufacturer's threshold. In this case, it would be technically possible to reduce opportunities for tax avoidance by reducing the current threshold from \$50,000 to \$30,000. A threshold of \$30,000 would also bring the threshold for the excise tax more in line with the small supplier threshold for the GST. Adding the requirement that sales by associated corporations be summed for the purposes of the threshold would also help contain avoidance.

Second, there is the \$3 administrative threshold for inexpensive jewellery. In this case, it would be possible to reduce opportunities for tax avoidance by modifying the current administrative rule. One example might be to assess imported shipments of jewellery components according to the value of the shipment, rather than on a piece-by-piece basis.

Third, the custom manufacturing provisions appear to warrant further consideration, particularly with respect to unlicensed manufacturers and the use of taxable inputs that are not tax-paid.

It should be noted, however, that these changes in the tax structure are not without difficulties. For example, reducing the small manufacturer's threshold would require more small manufacturers to pay the tax even though members of this group have already indicated that they find compliance with the excise tax to be a burden.

Overall, this study has found that the excise tax on jewellery has a number of structural flaws similar to the FST. Although eliminating the tax could draw some jewellery sales from the underground economy into the legitimate market, the shift is unlikely to be large enough to offset the government revenues lost by eliminating the tax. Also, the available evidence indicates that the elimination of the jewellery tax is unlikely to achieve a substantial reduction in the underground economy for jewellery. The size of the underground economy involves a number of factors including well-entrenched networks for illicit products. At the same time, this study has identified certain features of the tax that appear to be prone to tax avoidance and evasion. As a result, these structural and administrative features warrant further consideration.

ANNEX I

Methods Used to Estimate Jewellery Sales Escaping the Excise Tax

The estimates of jewellery sales escaping the excise tax were drawn from the background study entitled *Jewellery Excise Tax*. As noted in the background study, estimates of these sales cannot be derived directly from Statistics Canada data. Therefore, the background study has developed estimates using various sources of information. The methods used by the consultant are described below. Further details can be found on pages 32 to 46 of the background study.

■ *Estimate of manufacturer's avoidance*

To produce an estimate of manufacturer's avoidance, it is possible to begin with existing sources of information on the reported value of the inputs of gems and precious metals fabricated into jewellery. This information is then combined with information on markups and other costs to construct an estimate of total manufactured values and total retail sales for various segments of the jewellery industry. The markups used in this analysis were derived from interviews with members of the industry, and are believed to represent reasonable average values for various segments of the industry.

From this constructed information, it is possible to derive an estimate of the amount of excise tax revenue that would have been collected if the excise tax had been paid on all jewellery made from reported inputs. Using this methodology, it is estimated that excise tax revenues for 1990 would have been \$53 million. Since actual excise tax revenues for that year from domestic sales were \$36 million, the consultant concludes that the *excise tax is avoided on 32 per cent of manufacturing using inputs that are identified as going into the jewellery industry*. This result implies that manufacturer's avoidance occurred in respect of \$488 million in retail sales in 1990.

■ *Estimate of manufacturer's evasion*

To estimate manufacturer's evasion, the estimate of retail sales generated from known inputs (\$1,524 million) is compared with estimated retail sales derived from Statistics Canada information (\$1,800 million). The difference between these two estimates (\$276 million) is considered to provide an estimate of manufacturer's evasion. As indicated earlier, manufacturer's evasion is considered to occur when three conditions are met:

- inputs are not recorded as going into the jewellery industry;
- no excise tax is paid at the manufacturer's level; and
- the GST and other taxes are being paid in respect of the final product.

■ *Estimate of the underground economy*

Estimating the underground economy is particularly difficult. In an attempt to provide some sense of the size of this segment of the industry, the consultant uses information collected during interviews with members of the jewellery industry.

Interviewees estimated that the underground economy is equal to 30 to 60 per cent of the reported sales of the jewellery industry. While there is some uncertainty regarding what base to associate with the industry's estimates, the consultant interpreted the base to be \$1,524 million. As noted above, retail sales of \$1,524 million correspond to sales where the inputs are recorded as entering the jewellery and taxes are generally paid, although the excise tax appears to be avoided on about one-third of the sales. Using \$1,524 million as the base for the respondents' estimate is also consistent with the generally accepted view that tax avoidance is not an illegal activity.

With this approach, total domestic sales in 1990 are estimated to have been \$1,981 million to \$2,438 million. Comparing these two estimates to total reported sales of \$1,800 million for 1990, produces estimates for the underground economy of \$181 million to \$638 million in retail sales.