
Delimiting the Concept of Income: The Taxation of In-Kind Benefits

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The issue of which in-kind benefits should be taxed and how these benefits should be valued have concerned tax legislators, administrators, and academics since the introduction of the personal income tax system. Building her theoretical analysis on the income concept advanced by Henry Simons and relying on traditional tax policy notions of equity, neutrality, and administrative practicality, the author asserts that employees must be fully taxed on employer-provided in-kind benefits. To this effect, the article offers guidelines for distinguishing between taxable in-kind benefits and non-taxable conditions of employment. The author argues that the correct method of valuation of in-kind benefits is their fair market value, rather than the cost to the employer or the subjective value of the benefit to the employee. The article proceeds by revealing inconsistencies, inequities, and inefficiencies that have resulted from the manner in which Canadian tax administrators and courts have delineated taxability of in-kind employee benefits. Discussing such in-kind benefits as educational courses, employee trips, clothing, subsidized parking, and discounts on goods and services, the author makes suggestions that may be utilized to develop a matrix of detailed and consistent rules on the taxability of these and others in-kind benefits.

Depuis l'avènement du système d'impôt sur les revenus de particuliers, les législateurs, administrateurs et académiciens se soucient des questions posées par l'imposabilité et l'évaluation des prestations non-financières. Dans cet article, l'auteur affirme que les employés doivent être complètement imposés sur les prestations non-financières offertes par l'employeur. Elle fonde son analyse théorique sur le concept de revenu développé par Henry Simons et a recours aux notions traditionnelles de politique fiscales telles que l'équité, la neutralité et la praticabilité administrative. Cet article offre un cadre grâce auquel peut se faire une distinction entre bénéfices imposables et conditions d'emploi non imposables. L'auteur soutient que la méthode d'évaluation appropriée est la valeur sur le marché plutôt que le coût pour l'employeur ou la valeur subjective de la prestation pour l'employé. L'article révèle également des incohérences, des inégalités et des pertes résultant de la manière dont les autorités fiscales et les cours canadiennes ont délimité l'imposabilité des prestations non-financières offertes aux employés. L'auteur examine des bénéfices tels que les cours, les voyages, les vêtements, le stationnement subventionné et les rabais sur les biens et services, et offre des suggestions qui pourraient servir à développer une matrice réglementaire détaillée et cohérente sur l'imposabilité des prestations non-financières.

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That it should be possible to delimit the concept [of income] precisely in every direction is hardly to be expected. The task rather is that of making the best of available materials; ... one devises tools of analysis which are useful, if crude; and a tax base may be defined in such manner as to minimize obvious inequities and ambiguities. Such at least is the present task.

Henry C. Simons¹

Introduction: Kleinwächter's Conundrum—Is Attending the Opera with Your Employer a Condition of Employment or a Taxable In-Kind Benefit?

In his classic contribution to the intellectual development of the idea of a comprehensive income tax base, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*,² Henry Simons disparaged utilitarian attempts to define income by reference to notions of sacrifice, faculty, or ability to pay. Instead, to reduce opportunities for the government to meddle in the allocation of resources, but at the same time to make the income tax a more effective policy instrument for redistributing income earned in market transactions, Simons proposed that income be defined simply as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”³ Simon’s book was his attempt to show that based upon this formulation, a practical, conceptually coherent, and equitable income tax base could be enacted. His formulation is now widely accepted as the point of reference for the design of a comprehensive income tax base.⁴

Simons correctly anticipated that despite the practical value of his definition, the scope and limits of both of its components would be contentious.⁵ In recent years, tax

¹ *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938) at 43.

² *Ibid.*

³ *Ibid.* at 50.

⁴ Most notably, Canada’s Royal Commission on Taxation used Henry Simons’ work as the baseline for the development of a comprehensive income tax base in 1967. See Canada, *Report of the Royal Commission on Taxation*, vol. 1 (Ottawa: Queen’s Printer, 1966) at 9-10 (Chair: Kenneth LeM. Carter) [*Carter Report*].

⁵ At the outset of his treatise, Simons admits that it will not be possible to “define, establish, or adhere” to an ideal tax base (*supra* note 1 at 30). He adds, however, that “[a]lthough personal income is not amenable to precise definition, it has, by comparison to the concept of social income, a much

policy analysts have grappled, in particular, with the second part of Simons' definition—that income includes “the change in the value of a taxpayer's store of property rights.” The impracticality of determining this value annually has led all countries to tax income only when a change in the value of assets has been realized. This concession to Simons' definition is so significant that it has been referred to as the Achilles' heel of the income tax,⁶ and has led many public finance scholars to advocate the fairness, efficiency, and administrative advantage of a consumption over an income tax. This paper, however, focuses not on this second part of Simons' definition, but rather on the first part—the “market value of rights exercised in consumption.”

Simons conceded that the problem of defining the value of a taxpayer's personal consumption posed theoretical difficulties when dealing with such forms of income as the utility of leisure time, the imputed income from self-performed services, and the ownership of consumer durables.⁷ In particular, Simons notes that determining the market value of rights exercised in consumption by employees who receive in-kind benefits presents intractable difficulties. In illustrating this point, Simons referred to a German author, Friedrich Kleinwächter, who, Simons reports, “endeavors to discredit the whole concept of income by pointing out that some arbitrary delimitations are unavoidable” and “confounds himself and his reader with interesting conundrums having to do mainly with income in kind.”⁸ The problem of imposing tax equitably on an ordinary military officer as compared to a *Flügeladjutant* (a regimental aide-de-camp) to the sovereign is the most memorable of Kleinwächter's conundrums recounted by Simons. Although both receive the same cash salary, the *Flügeladjutant* “receives quarters in the palace, food at the royal table, servants, and horses for sport. He accompanies the prince to theatre and opera, and, in general, lives royally at no expense to himself and is able to save generously from his salary.”⁹ Simons complicates the problem by asking us to suppose that the *Flügeladjutant* detests opera and hunting.¹⁰ He laments that the problem this example poses to equitable taxation

smaller degree of ambiguity. Its measurement implies estimating merely the *relative* results of individual economic activity during a period of time” (*ibid.* at 49).

⁶ William D. Andrews, “The Achilles' Heel of the Comprehensive Income Tax” in Charles E. Walker & Mark A. Bloomfield, eds., *New Directions in Federal Tax Policy for the 1980s* (Cambridge, Mass.: Ballinger Publishing, 1983) 278.

⁷ However, for a whole host of administrative and political reasons, these kinds of income would likely not be subject to tax under even the most comprehensive tax base. See Boris I. Bittker, “A ‘Comprehensive Tax Base’ as a Goal of Income Tax Reform” (1967) 80 Harv. L. Rev. 925 [Bittker, “Comprehensive Tax Base”].

⁸ Simons, *supra* note 1 at 43, n. 3.

⁹ *Ibid.* at 53. For a translation of Kleinwächter's discussion of the position of this officer to the sovereign, see Friedrich Kleinwächter, *Das Einkommen und Seine Verteilung* (Leipzig: C.L. Hirschfeld, 1896) trans. by Hannelore McDowell (copy available in the Wake Forest University Law School Library) at 6.

¹⁰ Kleinwächter also offers this complication. See Kleinwächter, *ibid.* at 8.

“is clearly hopeless”. He states that “[t]o neglect all compensation in kind is obviously inappropriate. On the other hand, to include the perquisites as a major addition to the salary implies that all income should be measured with regard for the relative pleasureableness of different activities—which would be the negation of measurement.”¹¹ Given this perceived dilemma, Simons finesses the problem of distinguishing taxable from nontaxable in-kind benefits by suggesting that minimal amounts of in-kind compensation are provided to individuals, and that the in-kind compensation that is provided might be assumed to vary in a “continuous manner along the income scale”.¹² Simons reiterates this excuse for the nontaxation of many in-kind benefits no less than three times in his book.¹³ In his extended discussion of the taxation of income in kind, Simons adds to his list of reasons for the nontaxation of in-kind income the fact that it might be taken to offset the noninclusion of income from leisure activities.¹⁴

Over sixty-five years after the publication of Simon’s book, the taxation of in-kind benefits remains one of the most enduring problems in fashioning an equitable, efficient, and administrable income tax. The proposition that taxpayers should have to include in their income the value of in-kind benefits received as a result of their employment relationships—whatever form the receipt might take—seems uncontentious. However, problems arise in deducing the basic principles that might be used to define “rights exercised in consumption” and in giving the appropriate weight to the interests of equity, neutrality, and administrative practicality in formulating detailed rules. The purpose of this paper is not to resolve Kleinwächter’s conundrum but to continue Simons’ project of delimiting the concept of income by attempting to formulate reasonable guidelines for taxing in-kind benefits that will “minimize obvious inequities and ambiguities.”¹⁵

In developing and applying guidelines for taxing in-kind employee benefits, this paper proceeds as follows. Part I argues that in-kind benefits should be taxed because taxing them is in line with the evaluative criteria of traditional tax policy: equity, neutrality, and administrative practicality. Based upon the principles underlying the equitable, neutral, and simple taxation of income, Part II proposes guidelines that should be used for distinguishing between taxable in-kind employee benefits and employer-provided goods and services that should not be taxable. Part III explores the correct approach to determining the value of in-kind benefits. In particular, this part takes issue with the commonly held view that the theoretically correct method of valuing in-kind benefits is to determine the subjective value of the benefit to the employee. It is argued that employees should have to include in their income the fair

¹¹ Simons, *supra* note 1 at 53.

¹² *Ibid.*

¹³ *Ibid.* at 53, 113, and 124.

¹⁴ *Ibid.* at 113.

¹⁵ *Ibid.* at 43.

market value of all in-kind benefits that provide them with a personal benefit. Part IV reviews the tax treatment of selected in-kind benefits. This review draws on the guidelines developed in Part III and reveals inconsistencies, inequities, and inefficiencies in the manner in which the courts and Canadian tax administrators have defined taxable in-kind employee benefits. Where the treatment by the courts or the Canada Customs and Revenue Agency¹⁶ is inconsistent with the guidelines, more appropriate approaches to taxing particular in-kind benefits are suggested. The paper concludes by revisiting Kleinwächter's conundrum. The principles that should underlie the taxation of in-kind benefits and the guidelines proposed in Part III are referred to in delimiting the concept of income, even as it applies to the *Flügeladjutant*.

I. The Importance of Taxing In-Kind Benefits

Although unlikely to be accompanying their employers to the opera or on hunting trips, most contemporary employees receive myriad in-kind benefits. Many of these benefits (such as contributions to private pension plans, premiums for group accident insurance plans, private health insurance and group term life insurance, and counselling services) are specifically exempted from tax.¹⁷ The government has deliberately encouraged employers to provide these benefits to increase the economic security of employees and to relieve the government of future social assistance payments. These in-kind benefits are appropriately analyzed by applying budgetary criteria to determine, for example, whether they achieve their intended purposes. However, in addition to the benefits provided by these deliberate tax expenditures, employers frequently provide employees with a wide range of goods and services from which employees derive a personal benefit, including, for example, educational courses leading to a university degree, combined employment-related and pleasure trips, clothing, subsidized parking, trips taken with frequent flyer points, and discounts on goods and services. This paper is concerned with the proper tax treatment of these in-kind benefits.

¹⁶ In the article text, "Revenue Agency" is used to refer to the Canada Customs and Revenue Agency and to Revenue Canada (Canada Customs and Revenue Agency before the 1 November 1999 name change). On 12 December 2003, the Canada Customs and Revenue Agency changed its name again to the Canada Revenue Agency. See online: Canada Revenue Agency <<http://www.cra-adrc.qc.ca/agency/namechange-e.html>>.

¹⁷ For example, paragraph 6(1)(a) of the Canadian *Income Tax Act* (R.S.C. 1985, (5th Supp.), c. 1) exempts the following benefits from tax: employer contributions to a registered pension plan, group sickness/accident insurance plans, private health care services plans, supplementary unemployment insurance plans and deferred profits sharing plans, benefits under an employee benefit plan or an employee trust as a retirement compensation arrangement, and benefits derived from counselling services for health or re-employment or retirement.

The theoretical case for requiring employees to include the value of in-kind benefits in income for tax purposes is straightforward. To take the simplest case, if these benefits are items that an employee would otherwise purchase with after-tax income, from the employee's point of view, their receipt is equivalent to receiving cash. Thus, they clearly represent an increase in the employee's "market value of rights exercised in consumption."¹⁸ To illustrate, an employee who is provided with a \$2,000 recreational club membership by her employer and who would otherwise purchase such a membership for personal use has the same gross income as an employee who does not receive such a benefit but who receives an additional \$2,000 cash bonus. Equity demands that these two employees pay the same tax on this additional remuneration. Moreover, taxing in-kind benefits is important not only to ensure an equitable distribution of the tax burden, but also to ensure an efficient allocation of society's scarce resources. Failing to tax in-kind benefits reduces the after-tax cost of providing them and causes employers to alter compensation packages offered to employees. This tax-induced behaviour will result in social waste as resources are shifted from their market-determined best use. Thus, if employer-provided recreational gym memberships, for example, are not taxed, an employee in the forty per cent tax bracket who would otherwise purchase such a membership out of her after-tax income would prefer a club membership to a \$2,000 cash bonus even if the value of the membership to her were some amount below \$2,000, so long as it was above \$1,200.

Despite the apparently strong theoretical case for taxing in-kind employee benefits, some analysts have argued that the equity case for taxing them is overstated and that the distortions caused by their nontaxation are not serious. The nontaxation of some in-kind benefits is supported also on the ground that their taxation is administratively impractical and that nontaxation will further social policy goals. To underline the importance of getting the taxation of in-kind benefits correct, the traditional tax policy considerations of equity, neutrality, and simplicity are reviewed as they apply to in-kind benefits. In the course of this review, each of the arguments that have been made in support of an indifferent attitude to the taxation of in-kind benefits will be analyzed and shown to be wanting.

A. Horizontal Equity

The concept of horizontal equity requires that individuals who are similarly situated be treated the same. The difficulty arises in determining when two individuals are similarly situated for tax purposes. The implication of the Simons' definition of income from an equity perspective is that taxpayers should pay tax on the value of their personal consumption. Consequently, all in-kind benefits that provide an employee with a personal benefit should be subject to tax. Another way of stating this

¹⁸ Simons, *supra* note 1 at 50.

same point is to say that to the extent that an in-kind benefit is in substitution for a personal expense, the employee should be taxed on its value. A personal expense is an expense that provides the employee with a personal benefit, or an expense that originates from a personal decision.

Although the notion that the tax system will not be horizontally equitable if in-kind benefits are not taxed is intuitively appealing, and although much is made of the need for horizontal equity in debates over the taxation of in-kind benefits, some tax policy analysts, most notably Charles Clotfelter, have claimed that the concern over horizontal inequity in the nontaxation of in-kind benefits is not as compelling as is often contended for two reasons.¹⁹ First, Clotfelter argues that it is not practical to apply the concept of horizontal equity to the taxation of in-kind benefits since employees likely have very different tastes for different in-kind benefits. For example, in discussing Kleinwächter's conundrum, he notes that whether the officer in the field was taxed inequitably compared to the officer on the sovereign's personal staff, the *Flügeladjutant*, depends crucially on whether or not the *Flügeladjutant* had a taste for theatre, opera, horses, and the food served at the royal table. In asserting that the correct taxation of the *Flügeladjutant* requires knowing his preferences, Clotfelter assumes that the theoretically correct value of an in-kind benefit is its subjective value to the employee. But, as will be shown, this assumption is wrong. Employees should be taxed on the objective fair market value of the benefits they consume, as discussed in detail below.

Second, Clotfelter argues that not taxing in-kind benefits might not create horizontal inequities since, like with many apparent tax inequities, market mechanisms will compensate to neutralize the horizontal inequities resulting from the nontaxation of in-kind benefits.²⁰ In employment relationships, where significant value is provided to an employee in nontaxed benefits, cash wages will be lowered to reflect the provision of these tax-free benefits, leaving employees who receive nontaxed benefits no better off than employees who receive fully-taxed cash wages. Clotfelter argues that "to the extent that labor markets work efficiently and adjust rapidly, the attempt to apply this criterion [horizontal equity] by taxing fringe benefits will result in different before-tax wage differentials between jobs but no material improvement in horizontal equity."²¹

¹⁹ See Charles T. Clotfelter, "Equity, Efficiency, and the Tax Treatment of In-Kind Compensation" (1979) 32 Nat'l Tax J. 51 at 52.

²⁰ This argument is similar to that made by Boris Bittker in relation to providing tax concessions for income from capital assets: Boris I. Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?" (1979) 16 San Diego L. Rev. 735.

²¹ Clotfelter, *supra* note 19 at 53. The potential "capitalization" of the tax advantages of nontaxable in-kind benefits has also been noted by other scholars. See e.g. Thomas D. Griffith, "Efficient Taxation of Mixed Personal and Business Expenses" (1994) 41 UCLA L. Rev. 1769 at 1782.

The argument that bargaining between the employer and employee might remove a good deal of the inequity of not taxing in-kind benefits can be simply illustrated using the example set out earlier. Compare an employee who receives a nontaxed gym membership worth \$2,000 and an employee who receives an additional \$2,000 of taxable cash compensation. If the value of the gym membership is not taxed, there might appear to be a tax inequity between the two employees. However, assume that before the provision of this increased compensation, both employees earned \$60,000 and paid tax at a marginal rate of forty per cent. The employer might simply have approached the first employee and agreed to provide the \$2,000 membership if the employee accepted a \$3,333 reduction in her cash salary.²² If the employee agreed—because the gym membership provided by the employer was convenient and would not affect her after-tax position—then even though one employee was receiving a nontaxed in-kind benefit there would be no inequity between employees. The reduction in cash compensation paid to the employee receiving the nontaxed in-kind benefit would completely offset her tax advantage. The employer, in this example, captured all of the tax savings that arose from not taxing the in-kind benefit in the form of reduced wages. To put the same point a different way, if labour markets are operating efficiently, and if all nontaxable in-kind benefits were suddenly taxed, those employers providing significant nontaxed benefits as part of the employees' compensation packages might simply raise cash salaries so that the newly taxed employees were no worse off after tax than before the imposition of the tax.

There are, however, many reasons why labour markets may not operate as efficiently as assumed by this argument.²³ First, there is often a good deal of uncertainty about the value of the in-kind benefits an employee may receive in a year and, thus, the value of the benefits cannot be weighed accurately in the bargaining process. Second, the employees' salaries might not be reduced by the full value of the in-kind benefits they receive in a year simply because the costs of precisely calculating the value of those benefits are too great. Third, even if employees were aware of the precise value to themselves of the benefits they might receive in a year, since employers usually bargain with groups of employees and members in the group will have different marginal tax rates, the variation in salary would reflect the average value of that benefit to the employees, but would not perfectly reflect the actual value to each individual employee. In other words, if the employees are bargaining as a group and have different marginal tax rates, it is unlikely that the employer will be able to reduce each employee's salary by the amount required to fully capitalize the

²² \$3,333 is the amount the employee would have to receive before tax to be left with \$2,000 after-tax income when the tax rate is 40 per cent.

²³ Several commentators have criticized the general argument that the implicit tax created by an increase in the purchase price of a tax-free good or service (or a reduction of wages because of the receipt of a nontaxable in-kind benefit) may equal the explicit tax savings, thereby eliminating any inequities created by nontaxation. In the context of in-kind benefits, see *e.g.* William D. Popkin, "The Taxation of Employee Fringe Benefits" (1981) 22 B.C.L. Rev. 439 at 446-52.

value of the nontaxed benefit. Fourth, although employees likely bargain as a group, they may in reality receive different numbers of in-kind benefits. For example, one employee may have an opportunity to go on several business-related trips that can be extended into personal vacations, while another employee may not have access to those trips. The tax savings realized by individual employees in receipt of nontaxable in-kind benefits could not be captured in across-the-board wage settlements. Fifth, employees may be able to win some of the tax benefit realized on the receipt of nontaxable in-kind benefits either because of their bargaining power or because they may conceal their preferences about the value of the benefit. Sixth, even if employees who receive nontaxable in-kind benefits do not benefit from them since their cash salary is reduced by the tax saving, the nontaxation of in-kind benefits will inevitably produce windfall gains for someone—whoever can capture the tax savings: perhaps the employer, or the producer of the in-kind good or service. Finally, even if employees who receive nontaxed in-kind benefits paid an implicit tax in the form of reduced cash salaries, these implicit taxes would not, of course, result in government revenues. Thus, tax revenues must be recouped in some other way, and this may lead to inequities.

B. Vertical Equity

In addition to horizontal inequities, the nontaxation of in-kind benefits creates vertical inequities. The nontaxation of in-kind benefits is subject to the upside-down effect that is common to all exemptions from tax, as dramatically illustrated by Stanley Surrey in his repeated attacks on tax expenditures.²⁴ For example, the nontaxation of a gym membership with a value of \$2,000 saves an employee who earns \$100,000 and who is in the forty per cent tax bracket \$800 of taxes, but saves a taxpayer who earns \$30,000 and who is in the twenty-five per cent tax bracket only \$500 of tax.

More significantly, the nontaxation of in-kind benefits reduces the progressivity of the tax system because high-income taxpayers receive more nontaxable in-kind benefits than low-income taxpayers. Although whether or not high-income individuals receive a disproportionate number of nontaxable in-kind benefits is sometimes contested, it would seem logical to assume that in-kind benefits—if they are untaxed—will constitute a greater proportion of total compensation in higher-income occupations.²⁵ Higher-income employees likely have both a greater opportunity to structure their compensation packages to receive tax-favoured

²⁴ Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge, Mass.: Harvard University Press, 1973).

²⁵ The Organisation for Economic Co-operation and Development's report collected some statistics on the income level of recipients of in-kind benefits. It concludes that the provision of in-kind benefits "in terms of monetary value per recipient tends to increase as income increases ..." (Organisation for Economic Co-operation and Development, *The Taxation of Fringe Benefits* (Paris: OECD, 1988) at 23).

compensation and the bargaining strength to do so. This may be the case both because higher-income employees are more likely to be able to bargain individually (and therefore obtain their preferred mix of cash and in-kind compensation), and because they are more able to sacrifice cash payment for in-kind benefits. Moreover, if in-kind compensation is not taxed, the incentive to receive it will increase with the taxpayer's marginal tax rates. Unions also undoubtedly have some bargaining power in structuring the form of the compensation package of their members. But it is highly unlikely that low-income non-unionized employees are able to have any say over the form of their compensation.

Even if high-income taxpayers receive most nontaxed benefits, some economists have contended that there is ground for doubting whether vertical equity, or the progressivity of the tax system, would be significantly improved if all in-kind benefits received by high-income persons were taxed. Charles Clotfelter argues that for two reasons "most public finance economists would deny that the treatment of in-kind compensation is fundamentally a question of vertical equity."²⁶ First, he claims that in the same way that market adjustments might reduce the money incomes of those receiving untaxed, in-kind compensation and consequently erase horizontal inequities, market adjustments might also erase vertical inequities. Employers might be able to substantially reduce the cash salaries of those high-income individuals receiving a significant number of nontaxed in-kind benefits. Second, Clotfelter claims that, in any event, the potential to adjust the rate schedule to reflect any desired degree of progressivity makes vertical equity of less concern when considering the beneficiaries of tax expenditures or tax loopholes.

Clotfelter's arguments are not persuasive. High-income individuals are likely to have considerable bargaining power in setting their compensation packages, and there is no reason to assume that their employers, instead of the high-income individuals themselves, will benefit from tax concessions for in-kind benefits. Thus, in the gym membership example referred to above, if the employee is a high-income employee and is valuable to the employer, the employee may well approach the employer and suggest that instead of a \$100,000 salary, the employer could provide the employee with a cash salary of \$98,000 and a \$2,000 fitness membership. The employer would presumably be indifferent, and in this example, the high-income employee would capture all of the tax savings.

Clotfelter's second argument is even less persuasive. The value of the tax-free in-kind benefits received by high-income individuals likely varies enormously. It is hard to imagine how any conscientious legislator could sensibly take the receipt of these benefits into account in setting the rates for all taxpayers. A simple increase in the top marginal rate, for example, would tax all high-income earners more heavily on their taxable income, regardless of their receipt of in-kind benefits. For a taxpayer who

²⁶ Clotfelter, *supra* note 19 at 54.

receives a significant portion of her income in in-kind benefits, her tax liability may not increase very dramatically. Moreover, there are so many political constraints preventing changes to the progressivity of the rate scale that any effort to compensate for the tax-free income received by some high-income individuals is likely to be unsuccessful.

Finally, there is a perception of unfairness when some taxpayers, particularly high-income taxpayers, are able to receive nontaxed in-kind benefits, even if the tax savings they might obtain are fully compensated for by a reduction in salary. Taxpayers who have to pay for their vacation travel, automobile, commuting and parking, education, and entertainment out of after-tax dollars resent seeing other taxpayers arranging their affairs to receive tax-free compensation for these costs of living. The moral legitimacy of, and therefore compliance with, the income tax is threatened when taxpayers feel that others are able to take advantage of the system.

C. Neutrality

Another important criterion for judging a good tax system is neutrality. The tax system should not affect people's choices. According to the neutrality criterion, it should be assumed that people make choices that are in their own best interest and therefore, to the extent possible, their choices should remain after tax what they would be in a world without taxes.

In terms of the provision of in-kind benefits, if cash salaries are fully taxable but in-kind benefits that are valued by employees are not taxable, both employers and employees can be made better off after-tax by converting cash compensation to in-kind compensation. For example, if an employee in the forty per cent tax bracket belonged to a gym club with an annual fee of \$2,000, she would have to use about \$3,333 of her salary pre-tax to join the club. If the provision of a health club membership were a nontaxable in-kind benefit, her employer could provide it for her (instead of paying her \$2,000) and negotiate to reduce her cash salary by, say, \$800. Both parties would be better off. The employer's salary costs would be reduced by \$800 (assuming that the actual cost of the club membership to the employer is \$2,000) and the employee's after-tax income would be increased by about \$320.

As a result of the nontaxation of in-kind benefits—and the potential bargaining by employers and employees to take advantage of the resulting subsidies—a number of misallocations of resources will occur.²⁷ First, compensation packages will be distorted since employers will be induced to offer more in-kind compensation and less cash salary than they would in a tax-free world. Second, labour costs will be reduced in those occupations especially amenable to the provision of in-kind benefits; thus,

²⁷ See generally Clotfelter, *supra* note 19, and "Federal Income Taxation of Employee Fringe Benefits", Note (1976) 89 Harv. L. Rev. 1141 ["Federal Income Taxation"].

there will be excessive labour demand in those occupations. Third, resources will be shifted to industries producing goods and services used for nontaxable in-kind compensation; for example, if health club memberships are untaxed, more resources will be devoted to health clubs (and fewer to sidewalk cafés) than there would be in a world where people's choices were uninfluenced by taxes. Fourth, reflecting the increased demand because of their nontaxation, the price of goods or services that are provided as in-kind benefits will be driven up; they will therefore be more expensive for individuals who do not receive them as part of their employment. Finally, the undertaxation of in-kind benefits will cause social waste because employees will be better off after-tax consuming nontaxable in-kind benefits, even though the value of the benefit to them does not equal its cost.²⁸ In the above example of the health club membership, if the employees are required to purchase the membership out of after-tax income, employees will not join a fitness club with a \$2,000 annual fee unless it has a value of \$2,000 to them. However, if the employer provided the membership in a nontaxable form and employees were in the forty per cent tax bracket, employees would be better off joining the club and taking a \$2,000 reduction in salary if joining the club were worth any amount over \$1,200 to them. If taxpayers were induced to join fitness clubs that have a cost of \$2,000 but a value to them of only \$1,200, \$800 of society's resources would be wasted.

D. Administrative Practicality

Those who generally support the nontaxation of in-kind benefits frequently note the administrative difficulties of taxing them. The administrative difficulties are of two kinds: tracking issues and valuation issues. An employer may have a tedious, challenging, or potentially impossible task if required to keep track of every in-kind benefit received by every employee. In addition to tracking issues, the value of some in-kind benefits is hard to determine since there may be no identical good or service for sale in the market. Thus, employers may have difficulty determining how much to withhold and remit from an employee's paycheque based on the increase in income to the employee from the receipt of the in-kind benefit. Also, determining how other taxes and premiums must be accounted for can be difficult—for example, an employer will need to determine if goods and services tax is due or whether an additional premium should be submitted on account of Canada Pension Plan contributions. Therefore, the compliance costs of collecting a tax on in-kind benefits

²⁸ This point was emphasized by Calvin Johnson, who presents the example of an employee who consumes a \$50 lunch that is only worth \$25 to him. Commenting on the economic waste involved in this rational decision, Johnson states that “[i]n consuming a \$50 lunch which is worth only \$25 to him, the employee wastes \$25—as surely as if he had burned dollar bills. But as long as the lunch is exempt from tax the employee's choice is rational, because the resources he wastes are less than the tax he would pay on cash” (Calvin H. Johnson, “The Case for Taxing Fringe Benefits” (1979) 9 Tax Notes 43 at 43).

could be high. Although these administrative difficulties undoubtedly arise when some kinds of in-kind benefits are provided, for most kinds of in-kind benefits bright-line tests can be formulated that reduce the administrative cost of imposing a fair tax on those benefits and that address the difficulties of determining their value.

E. Social Policy Considerations

Finally, social policy considerations might suggest that some in-kind benefits should not be taxed. This is the justification that is generally accepted for permitting employers to provide some forms of social insurance benefits tax-free. Based on social policy justifications, many taxing statutes provide specific exemptions for pensions and various other forms of social insurance. These benefits are widely considered to be spending programs delivered through the tax system, as discussed in the introduction to this paper. In addition, taxing bodies will often provide administrative concessions for social policy reasons in their approach to enforcing legislation, or courts will interpret legislation in a way that recognizes social policy concerns. However, where such concessions are given for social policy reasons, they should be evaluated as tax expenditures and not technical tax measures and therefore, the proper analytical questions are: what government purpose is being served by the provision? What other policy instruments might have been used to achieve this purpose? Is the provision target-efficient? Is the provision easy to administer and comply with? Does it systematically disadvantage any group of people? Although these questions will not be addressed in this paper, as measures to advance social policy goals, the nontaxation of in-kind benefits will often fail all of the traditional criteria of a sensible government spending provision. For example, the concessions are unfair since the implicit government subsidy that taxpayers receive depends upon their marginal tax rates, hence larger benefits are provided to higher income than lower income employees; the concessions are invariably target-inefficient since they are usually only provided to unionized or other employees who have some bargaining strength; and, like in all government spending programs delivered through the tax system, the government is less accountable for the concessions and has less control over them than it does in direct spending programs.²⁹

II. Determining the Boundaries of Taxable In-Kind Benefits

The income tax legislation contains only a general charging provision to address the taxation of most in-kind benefits, but no specific guidance as to how to distinguish a taxable in-kind benefit from an employer-provided good or service that should not

²⁹ For the classic, and now widely accepted, analysis of the inequities and inefficiencies created when government spending programs are delivered through the tax system, see Surrey, *supra* note 24.

be subject to tax.³⁰ Paragraph 6(1)(a) simply provides: “There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment ... the value of board, lodging and other benefits of any kind whatever received or enjoyed by the taxpayer in the year in respect of, in the course of, or by virtue of an office or employment ... ”³¹ It has been left to the courts and the Revenue Agency to develop the matrix of rules required to tax the full array of in-kind benefits that employers typically provide to employees. In crafting these rules, judges and administrators have to carefully balance the considerations that lie behind the traditional tax policy evaluative criteria of equity, neutrality, and administrative practicality. In this part, guidelines that should be used in fashioning these rules are set out under each of these evaluative criteria.³² A number of existing guidelines that are clearly inappropriate are then briefly reviewed.

A. Equity

An equitable policy relating to the taxation of in-kind benefits would ensure that two employees who consume the same value of personal goods and services are taxed the same way. The role of the guidelines derived from the equity principle is to assist in determining when an employee has derived a personal benefit from in-kind goods and services provided by her employer. The guidelines suggest facts and circumstances that tax administrators should consider in drawing a factual inference about whether an employee has obtained a personal benefit.

Perhaps one of the most obvious considerations in deciding whether an employee has derived a personal benefit from the provision of an in-kind good or service is simply the nature of the good or service itself. Some goods and services are used largely or entirely for personal purposes (e.g., food, clothing, and shelter); they would have been acquired by the taxpayer even in the absence of employment. Although it is possible to imagine circumstances where an employee would derive no personal benefit from obtaining from her employer everyday clothes that might be worn outside the work environment, it is reasonable to assume that most employees would always derive personal pleasure or use from the provision of these kinds of goods or services. As a result, these kinds of benefits should always be fully taxed in the hands of the employee.

³⁰ There is, however, legislation governing the taxation of some specific benefits. See, for example, subsections 6(19)-(22) of the *Income Tax Act*, *supra* note 17, which govern reimbursements for loss in the value of housing; subsection 6(15), which applies to employee debt forgiveness; or section 7, which addresses employee stock options.

³¹ *Income Tax Act*, *ibid.*

³² In the mid-1970s, two outstanding articles were published on the development of guidelines for distinguishing between personal and business expenses: Daniel I. Halperin, “Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem” (1974) 122 U. Penn. L. Rev. 859; and “Federal Income Taxation”, *supra* note 27.

In contrast, some other goods and services are rarely used for personal enjoyment and are essential for employees to discharge their employment-related duties. These kinds of goods and services should always be regarded as conditions of employment and should not be taxed. Tools of a trade are an obvious example. Even though some eccentric individual may purchase a stethoscope or rent a backhoe for personal pleasure, this is so unlikely that the provision of these kinds of tools should never give rise to a taxable in-kind benefit. The lack of personal use of these goods and services by most people provides strong evidence that they do not provide any personal benefit to the employee who receives them.

Some goods and services both provide individuals with personal satisfaction and can be used to earn income. In the context of employment-related activities, it is often difficult to tell whether an employee is deriving a personal benefit from these dual-purpose goods and services. Education, travel, and entertainment are only a few of the goods and services that might in some contexts provide a personal benefit and in other contexts be used solely to earn income. The following considerations would appear to be relevant in drawing an inference as to whether employees are deriving a personal benefit from these goods or services that are provided in an employment-related context.

First, if a benefit is widely provided in a particular industry in a non-discriminatory fashion within each work environment, it might be inferred that the employees are deriving no personal benefit from the provision of the good or service, but instead that solely an income-earning aim is being served. Employers are unlikely to attempt to disguise compensation to employees by providing benefits indiscriminately to them. Of course, in some cases, it might be that certain personal benefits have simply become a compensation norm and they are, therefore, widely provided. However, even if it is the case that employees derive some personal benefit from the provision of a particular widely provided good or service, if the benefit is widely provided in a non-discriminatory fashion, any inequities created by not taxing it are not likely to be significant. In other words, if most employees in a particular occupation receive offices with windows, there is no great horizontal inequity in not taxing the value of a window as a fringe benefit. On the other hand, if expensive artwork is rarely provided to employees, then horizontal and vertical inequities are created if the imputed rental value of employer-provided artwork is not taxed to the employees who receive such artwork since other employees would have to decorate their offices with artwork purchased out of after-tax income.

In addition, the requirement that the benefit be provided in a non-discriminatory fashion within one work environment ensures that, to the extent the provision of the benefit will be inequitable between employees in separate work environments, the tax savings of the benefit are more likely to be capitalized in the salaries of the employees, therefore resulting in less interoccupation inequities. For example, if all employees in office A receive free coffee, their salaries should be reduced to take into account the price of the coffee. Employees in office B, who do not receive free coffee,

should have a slightly higher salary. As reviewed above, the capitalization of the price of the benefit in the employees' salaries will be imperfect and should not be relied upon to alleviate inequities as a general rule. The capitalization effect will, however, make the inequities less significant when the benefit is provided in a non-discriminatory fashion.

Second, the more important the good or service in the direct performance of the work of employees, the less likely it is to be providing a personal benefit to employees. The ultimate question that must be answered is, of course, whether or not employees are deriving a personal benefit from the provision of a particular good or service, not whether the good or service is being provided for employment-related purposes. However, the fact that the good or service is necessary for the discharge of employment-related activities is relevant in drawing an inference about whether it is also providing a personal benefit to employees. If employees could not do their job without the particular good or service, it is less likely to be serving a personal purpose. This inference is strongest if the good or service does not appear to be necessary for employees to do their job. In this case, the inference that it is providing a personal benefit to employees is compelling.

Third, if a good or service provided to employees has a luxury element, there is a strong inference that employees are deriving some personal benefit from it. That is to say, if the good or service is more expensive or lavish than that which would appear to be required to earn income, it may be inferred that the employees are enjoying some personal benefit from the provision of the good or service. For example, employees might require vehicles to discharge their employment responsibilities, but if they are being provided with luxury automobiles, they may be assumed to be receiving a personal benefit.

Fourth, if a good or service is being provided to employees because of some personal decision that they made, it can be assumed that it is providing them with a personal benefit. The most obvious examples are commuting and childcare costs. All expenses that originate in a personal decision are assumed to be the result of that personal decision and are treated, therefore, as personal expenses for tax purposes. It is generally assumed that employees are able to make a personal decision about where they would prefer to live. Therefore, if they choose to live some distance from their place of employment, their commuting expenses are assumed to be personal expenses. If an employer pays for these commuting costs or provides commuting services, the employee will receive a personal benefit that should be included in income. Of course, it is unrealistic to assume that all employees freely choose where to live. Housing costs, zoning bylaws, and a host of considerations over which employees have little control often determine where they live. However, it would obviously be impossible to determine on an individual basis precisely why individual employees chose to live in particular locations. All commuting costs are therefore deemed to be personal expenses. The same reasoning applies to childcare expenses. Employees, like everyone else, presumably make a personal, not an employment-

related, decision to have children. Therefore, the tax system should consider the expenses of childcare to be personal expenses. If an employer provides childcare facilities for employees or otherwise pays for the employees' cost of childcare, the employees have received a taxable benefit.

B. Neutrality

Tax rules should be drafted so that to the extent possible the choices that individuals make are not affected by tax considerations. This suggests that the more likely it is that not taxing a particular in-kind benefit will cause employees and employers to change their compensation practices, the more important it is that the benefit be taxed. Put another way, the easier it is for an employer to substitute an in-kind benefit for cash compensation, the stronger the argument in favour of taxation. The failure to tax these benefits at their fair market value³³ will inevitably lead to inefficiencies in the allocation of resources. Of course, it is impossible to draft rules that are completely neutral. Despite the best of intentions, on occasion the decision to tax or not to tax particular in-kind benefits will affect the decision of whether or not to substitute the benefit for cash compensation. In these cases, tax authorities should consider whether the additional provision of the in-kind benefit is justifiable from a policy perspective.

C. Administrative Practicality

Ultimately, rules that depend upon objective facts and circumstances have to be used to assist decision-makers who are required to determine whether an employee has received a taxable in-kind benefit and to determine the benefit's value. In many cases, it has been the perceived administrative complexity of taxing in-kind benefits that has led to their undertaxation.

Rules governing the taxation of in-kind benefits should be reasonably cost-efficient to administer, easy to comply with, consistent in their application, and difficult to avoid or evade. Often, particularly for in-kind benefits that serve both an income producing and a personal purpose, bright-line rules are required. For example, rules may be required that do not purport to measure precisely the value of the personal consumption that a particular employee might enjoy on a trip that combines employment-related responsibilities and a vacation. Instead, in attempting to arrive at this judgment, the rule might depend on a small number of readily verifiable facts and circumstances, such as an arbitrarily defined number of days that the employee spent on employment-related activities as compared to vacation activities. These bright-line tests, which are intended to act as proxies for theoretically more accurate but difficult

³³ See Part III, discussing why fair market value is the proper measure of valuation of in-kind benefits.

to apply tests, may give rise to some inequities that could be avoided if a more comprehensive facts and circumstances test were applied. Nevertheless, in many cases the administrative advantages of using such bright-line tests outweigh the small inequities sometimes created. Administrative practicality also counsels that in-kind benefits that only have a small value should generally be ignored. Finally, as a decision-making rule in this area, where an in-kind benefit is provided and the personal value of the benefit is uncertain, the employee should be taxed.³⁴ Failing to tax in-kind benefits that provide employees with personal benefits creates inequities and inefficiencies.

D. Occasionally Referred to but Inappropriate Guidelines

Over the years, the courts and tax administration have sometimes referred to tests for determining whether an in-kind benefit should be taxed that are inappropriate. For example, until fairly recently, one of the most frequently referred to doctrines relating to in-kind benefits was that a benefit should not be taxed unless it could be converted into cash. It is obvious that an employee who receives a good or service from her employer that she would otherwise have to purchase with after-tax income has received a benefit, whether or not that benefit can be converted into cash. There is simply no reason to conclude that an employee's inability to resell a benefit means the benefit has no value. At best, it might be argued that an inability to resell a benefit might reduce its value to the employee because one of the property rights associated with the benefit (free transferability) has been restricted.

Occasionally it has been suggested that if an employee has no choice about the receipt of a benefit, the employee should not be taxed on the value of the benefit. Again, this makes little sense. If the benefit relieves the employee of an expense she would normally incur for a personal purpose, it is logical to infer that she received some personal benefit from it even though it might have been received involuntarily. At best, the fact that it was received involuntarily might affect the value of the benefit. In any event, in most cases the provision of the benefit is unlikely to be "involuntary" to the employee in the long run. If the employee does not value the benefit equally to the amount of cash salary she will have to give up to attain the benefit, or equally to the amount of tax she will have to pay for the benefit, then the employee will bargain for a better contract without the benefit. Indeed, if the employee values the benefit at less than its actual value, the tax system should encourage the employee to bargain to stop receiving the benefit thus avoiding the economic inefficiency of the benefit's provision.

³⁴ This is also the position favoured by Halperin, *supra* note 32 at 894-95, and Johnson, *supra* note 28 at 45. See also Boris Bittker, who argues that "the business necessity of borderline expenditures is hard to prove or disprove, while their personal component is usually clear, with the result that deductions in this area cannot be adequately policed and will therefore breed exaggeration, fraud, and public discontent" (Bittker, "Comprehensive Tax Base", *supra* note 7 at 953).

Another test that is sometimes used in determining whether an employer-provided good or service should be taxable is whether or not it was provided for the employer's convenience. If the benefit was provided for the employer's convenience, this inappropriate guideline would suggest that it should not be taxed. The problem with the way this test is often stated is that it confuses the ultimate question that must be answered in deciding whether an in-kind benefit should be taxed with the facts and circumstances that might be relevant in inferring the answer to the question. In deciding whether an in-kind benefit should be taxed, the question always is whether or not the employee derived a personal benefit from its provision. In answering this question, a relevant fact to consider might be whether the benefit was provided for the employer's convenience. If it was provided for the employer's convenience, it might be less likely that the employee derived a personal benefit. Certainly it makes it more likely that the employee derived a personal benefit if the employer had no reason for providing the benefit other than to compensate the employee. However, while whether the benefit was provided for the employer's convenience might be a relevant fact in determining whether the employee derived a personal benefit, it should not be treated as the test itself.

Employers can often provide some goods or services to employees at very little cost to themselves. It is sometimes argued as a result that because these benefits are provided at no substantial cost to employers, they should not be taxed in the hands of employees. However, the obvious reason for discarding this test is that it is the employee's income that is in issue. The employer's cost of providing these goods is irrelevant to this issue. It is sometimes suggested that the justification for the nontaxation of goods and services that an employer can provide to employees at no substantial cost is that it encourages the consumption of goods and services that would otherwise be wasted. There are, however, four reasons why this justification is untenable.³⁵ First, the nontaxation of goods or services that can be provided to employees at no cost to employers gives an incentive for employers to create such additional kinds of benefits to compensate employees. Second, the ability to provide no-extra-cost goods or services to employees tax-free reduces the incentive to find a mechanism for selling those items on the market. Third, economic distortions created by the tax-free provision of such benefits may be more significant than the potential waste of goods or services that are not consumed. Fourth, it is unlikely that any goods or services that could be provided by an employer are truly costless. In addition to the opportunity costs, there are likely real costs. For example, where an airline employee receives a free flight in an unused space, the airline will incur additional administrative costs, baggage-handling costs, gasoline costs, meal costs, and potential liabilities.

³⁵ See Joseph M. Dodge, *The Logic of Tax: Federal Income Tax Theory and Policy* (St. Paul, Minn.: West Publishing, 1989) at 299-300; "Federal Income Taxation", *supra* note 27 at 1162-63.

The principal purpose test is the final test reviewed in this section that is occasionally employed by tax administrators but that fails as a test for the correct taxation of in-kind benefits. Under a principal purpose test, if the principal purpose of the provision of the good or service by the employer is business, then the benefit is exempt from tax altogether. Conversely, if the principal purpose of the provision of the good or service is to benefit the employee personally, then the full value of the benefit is taxable to the employee. The principal purpose test is normally inappropriate for five reasons. First, it can be easily manipulated. The principal purpose test normally relies on a large number of factors that can be over or underemphasized by taxpayers or decision-makers to justify a sought-after result. Second, it presumes the existence of a decision-making process that may not have occurred. Third, in theory, under the principal purpose test, a slight change in facts could result in significant tax differences. For example, an employee who takes a trip motivated forty-nine per cent by business might be taxed on its full value, while another employee motivated fifty-one per cent by business would not be subject to tax. Fourth, and perhaps most importantly, the test is far from a suitable proxy for the personal benefit of the good or service provided to the employee. The employer's purpose is, in and of itself, simply not relevant except to the extent to which it can be used to draw an inference about the personal benefit to the employee. In most cases, this inference would be weak. In any event, the principal purpose test is commonly employed to find a good or service either fully taxable or tax-free to the employee. A more refined and accurate assessment of the personal benefit derived by the employee is normally feasible. Finally, if objective criteria are used as indications of the primary purpose of providing a particular in-kind benefit, they are often easily avoided. For example, if an inference about the primary purpose of a trip is based on the number of days spent at a particular location, employees can always arrange to have their business days outnumber their personal days.

III. Determining the Value of Taxable In-Kind Benefits

One of the reasons that taxing in-kind benefits has appeared to pose such a challenge for the income tax is that there is no agreement as to the appropriate method of valuing them. Some judges and legislators have assumed that the value of in-kind benefits should be the amount that an employee could receive by reselling the benefit. Others have suggested that the appropriate value is the cost of the benefit to the employer. However, in theory, it is easy to see why neither of these methods can be correct. The purpose of taxing in-kind benefits is to ensure that employees pay tax on the value of all compensation they receive by virtue of their employment. The "resale value" method assumes that employees do not receive anything of value from a benefit they cannot convert to cash. The "cost to the employer" method assumes that the value of the benefit to the employee will equal the cost of the benefit to the employer. Both of these empirical assumptions are wrong. Employees may receive a huge personal benefit from employer-provided goods and services even though they cannot sell the goods and services, and there is no reason for supposing that the value of a benefit to an employee should be in any way related to its cost to the employer.

More plausibly, a number of commentators have suggested that the theoretically correct method of valuing in-kind benefits is to determine their subjective value to individual employees, that is, the value of the cash compensation an employee would give up to receive the benefit.³⁶ If this were the correct method of valuing in-kind benefits, then the taxation of in-kind benefits would truly be perplexing. It would be impossible to determine this value in most cases and even if it could be determined, taxing two employees differently based upon their subjective assessment of the value of an employer-provided in-kind benefit could lead to strange results. It might mean, for example, that lawyers who were accustomed to dining out would be taxed at a much lower rate on firm-provided meals than law clerks. Fortunately, the correct income tax value of employer-provided in-kind benefits is not their subjective value to employees, but simply their fair market value.

The fair market value of employer-provided goods and services that an employee consumes is the correct measure of income because one important purpose of the income tax is to redistribute economic resources. Therefore, it makes sense that the base upon which the tax is levied is the objective value of the economic resources consumed by the taxpayer, and not the taxpayer's subjective valuation of those goods and services. Indeed, no one since Simons has seriously suggested that the tax system should be used to try to equalize the subjective utility that individuals derive from goods and services they consume.³⁷ Instead, most theories of distributive justice are based on the assumption that what should be redistributed is the resources that individuals have available for consumption, and not the pleasure they derive from that consumption.

The insight that the tax system should measure income in a fashion that reflects its primary purposes—and in particular its redistributive purpose—was one of Simons' great contributions to tax policy debates. He argued that what should be subject to tax is the "exercise of control over the use of society's scarce resources."³⁸ Parenthetically, it appears as though Simons himself did not fully appreciate the

³⁶ See especially Halperin, *supra* note 32 at 880; International Fiscal Association, *The Taxation of Employee Fringe Benefits: A Report Based on the Proceedings of a Seminar Held in Florence, Italy, in 1993 During the 47th Congress of the International Fiscal Association* (The Hague: Kluwer Law International, 1995) at 41-42; Avery Katz & Gregory Mankiw, "How Should Fringe Benefits be Taxed?" (1985) 38 Nat'l Tax J. 37 at 38; William A. Klein, "The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis" (1966) 18 Stan. L. Rev. 1099 at 1103; Joel S. Newman, "Transferability, Utility, and Taxation" (1981) 30 U. Kan. L. Rev. 27 at 42; Organisation for Economic Co-operation and Development, *supra* note 25 at 16; Popkin, *supra* note 23 at 442. These commentators recognize, however, that the subjective method of valuing in-kind benefits is administratively impractical.

³⁷ See Michael J. McIntyre, "What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report" in W. Neil Brooks, ed., *The Quest for Tax Reform* (Toronto: Carswell, 1988) 189 at 205-206.

³⁸ Simons, *supra* note 1 at 49.

significance of his arguments about the importance of focusing on the redistributive purposes of the income tax in defining the concept of income in his treatment of in-kind benefits. That Simons contemplated an objective value for the measurement of income is clear because he defined income as the “market value of rights exercised in consumption.”³⁹ When discussing the measurement of personal income during a period, Simons refers to market values, stating that “this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.” Later he reiterates that “[t]he essential connotation of income, to repeat, is *gain*—gain to someone during a specified period and measured according to objective market standards.”⁴⁰ Despite this clarity about the need to determine income by reference to market values, Simons’ discussion of the *Flügeladjutant* suggests that in the context of in-kind benefits he loses his focus on the importance of an objective standard. He writes:

[t]he problem of Kleinwächter’s *Flügeladjutant* is insoluble and certainly is not amenable to reasonable solution on the basis of simple rules which could be administered by revenue agents. Obviously there are many instances where taxpayers are too favorably treated. The sporting-goods salesman, who lives at the best hotels and clubs and spends much time entertaining good customers “on the company,” might well be taxed on something more than his salary—providing he doesn’t dislike such life, as the *Flügeladjutant* did the operas!⁴¹

Why does the sporting-goods salesman’s enjoyment of his job matter when an objective measure of income is being applied? Why should Simons be concerned about redistributing the enjoyment of an opera? As suggested above, these issues can be resolved appropriately only if the fair market value of in-kind benefits is adopted as the correct standard. Noting that no one has seriously suggested that employees should pay tax on the value of their consumer surplus when their subjective value of an in-kind benefit exceeds its fair market value might reinforce the intuition that the fair market value of goods and services consumed by employees is the correct method for valuing in-kind benefits.

Some commentators have argued that the tax criterion of neutrality supports the subjective valuation of in-kind benefits.⁴² Only if tax is levied on the employee’s subjective value of the in-kind benefit will the employee remain neutral between the receipt of cash compensation and in-kind benefits. Assume A’s employer offers her a gym membership in a recreational facility valued in the market at \$2,000, but available to the employer at a discount. Assume also that A would only have paid

³⁹ *Ibid.* at 50 [emphasis added].

⁴⁰ *Ibid.* at 51 [emphasis added].

⁴¹ *Ibid.* at 123.

⁴² See “Federal Income Taxation”, *supra* note 27 at 1144; and John S. Nolan, “Taxation of Fringe Benefits” (1977) 30 Nat’l Tax J. 359 at 361.

\$1,200 for the membership. In the absence of tax, A would choose the membership if the cash compensation offered in lieu of the benefit were less than \$1,200. This choice is preserved if the benefit is taxed at its subjective value. If, however, A is taxed on the fair market value of the benefit, A would only choose the gym membership if cash compensation less than \$667 were offered in lieu of the benefit (assuming a forty per cent tax rate).⁴³ Therefore, the adoption of the fair market value has changed A's compensation choice in the presence of tax.

While it is true that adopting a market value for in-kind benefits might alter pre-tax behaviour, the pre-tax behaviour in this case is undesirable. In the example provided above, A chooses to receive a benefit valued at less than its fair market value. Arguably, society's scarce resources would be better allocated if she chose the cash compensation and purchased something that she valued at its fair market value, leaving the gym membership to be purchased by someone who values it at its fair market value. If the gym membership is valued at its fair market value for tax purposes, A may ultimately choose the membership over cash compensation (at the point where she is offered \$667 or less as cash compensation), but the possibility that A will waste society's scarce resources is reduced when this approach is adopted.

Finally, as a pragmatic matter, taxing regimes must (and generally do) rely only on objective measures of income in assessing taxpayers' liability to be administered effectively. The subjective value of an in-kind benefit is impossible to determine, and taxpayers would have an overwhelming incentive to misrepresent their subjective value. Proponents of a subjective value in theory inevitably concede that it would be impossible to adopt in practice. Also, in most cases it is reasonable to assume that the value of an in-kind benefit to an employee equals the fair market value of the benefit. Most employees who receive significant nontaxed in-kind benefits, such as high-income employees and union members, negotiate for the benefits they receive. Presumably, they only negotiate for benefits they value as much as the benefit's fair market value. Even if a benefit is imposed on employees, it is reasonable to assume that employers provide in-kind benefits with compensatory value to employees to ensure employees remain loyal and demand less cash compensation.

⁴³ If the fair market value of the membership were subject to tax, A would pay \$800 in tax (40 per cent of \$2,000). This leaves A with \$400 of after-tax value (\$1,200-\$800). Therefore, A would choose cash compensation any time she were left with more than \$400 after tax. If A received \$667 cash, she would pay \$267 in tax and be left with \$400 after tax. Therefore, if A is taxed on the fair market value of the benefit, after tax A is indifferent between receiving the gym membership and \$667 in cash.

IV. Evaluation of Present Law and Practice

This part of the paper deals specifically with the approach to the taxation of six in-kind benefits and makes suggestions for the proper taxation of each. At a general level, the taxation of all these benefits presents the same issues: a determination of the extent of the personal consumption element associated with provision of the benefit, and the need to formulate a rule that can be administered that will distinguish between those cases where that personal benefit is sufficient to justify taxation and those where it is not. The six benefits have been chosen because they illustrate some of the common difficulties that arise in the taxation of in-kind benefits highlighted in the discussions earlier in the paper. Education and travel provide illustrations of typical dual-purposes benefits. Even though it has enormous income-earning potential, university education is an inherently personal good and not taxing this good when paid for by an employer leads to obvious inequities and perverse incentives. Employer-provided travel benefits illustrate the need for arbitrary bright-line rules for ensuring that employees are taxed on the value of their personal benefits. Clothing (other than uniforms) is a good that everyone must purchase personally, whether employed or not. Therefore, in most cases, the value of employer-provided clothing should be included in income. Parking is a subset of the commuting expense rule, and inclusion of the value of the benefit in income should be required because the expense is the result of a personal decision. Tax administrators have had difficulties with frequent flyer points primarily on administrative grounds, yet the inequities and inefficiencies created by the nontaxation of flights taken when business-earned points are cashed in is enormous, and a concession to administration is inappropriate in this area. Finally, discounts on goods and services are discussed to provide an example of how the justification for nontaxation where there is no additional cost to the employer has inappropriately pervaded some areas of in-kind benefits taxation. Although this paper focuses on whether each of these benefits should be taxed when received by employees, the same analysis could be applied in determining the appropriate deduction of these expenses when they are incurred by people who earn income from a business.

A. Educational Courses Leading to a University Degree

Generally, it is not hard to distinguish between education provided by an employer that has no personal benefit to employees and that, therefore, should not be taxable, and education provided by an employer that does give employees a personal benefit and that should be subject to tax. On the one hand, for example, if a law firm pays for a tax associate to take a two-day continuing legal education course on the taxation of fringe benefits, there seems to be little doubt that the course should be treated as a nontaxable benefit. All the relevant facts and circumstances suggest that there is little personal benefit in such a course. Few, if any, individuals take a course on the taxation of fringe benefits to further their liberal education or for amusement; the information provided in the course is directly required to earn income; also, the

course is likely offered to all employees working in related areas of legal practice. Moreover, not taxing the value of these courses is unlikely to change the compensation packages that law firms offer to their associates. Presumably, few employees would choose to exchange cash compensation for a course on the taxation of fringe benefits.

On the other hand, if a law firm pays for a tax associate to take a weekend course on the collected works of Margaret Lawrence, that course should be treated as a taxable benefit. The personal benefit of enrolling in such a course is likely to be high: it is the kind of course that individuals take regardless of the nature of their employment; there is no immediate relationship between the course and the employee's income-earning capacity; and the course will likely be taken by only some employees. Moreover, if the value of courses like this were not taxed, it is likely that employees would negotiate to have them paid for by their employers in lieu of cash compensation.

Although most courses paid for by employers for the benefit of their employees are relatively easy to classify as providing a personal benefit to the employee, some educational courses provided by employers are classic dual-purposes benefits. The most obvious example of a dual-purpose course—and one that has caused considerable controversy in Canada in recent years—is a course leading to a university degree. Many students who attend university undoubtedly do so in large part to further their careers. Considerable evidence suggests that a university degree can significantly increase an individual's earning capacity. At the same time, university courses provide students with large personal benefits. These personal benefits include the acquisition of a more diverse body of knowledge about the world, the development of critical thinking skills that are used in all facets of everyday life, the expansion of intellectual powers generally, the elevation of social status, and the feeling of self-accomplishment and personal satisfaction. In light of the fact that courses leading to a university degree serve both of these purposes, what should the tax treatment be when such courses are paid for by an employer? In Canada, this question has arisen recently in the context of employers paying for the costs of MBA degrees acquired by their employees. Given that the tuition for these degree programs can exceed \$65,000, the issue is not trivial. A brief review of the recent public debate over the taxation of employer-sponsored university degrees will serve to raise many of the issues relating to whether they should be considered a taxable benefit.

Prior to a change in its policy in the late 1990s, the Revenue Agency's general administrative position was that if fees for an educational course were paid on behalf of an employee, the fees were a taxable benefit to the employee, unless the course was taken primarily for the benefit of the employer and was taken at the employer's initiative.⁴⁴ The Revenue Agency would presume that the course was for the benefit of

⁴⁴ Revenue Canada, Interpretation Bulletin IT-470R (unconsolidated), "Employees' Fringe Benefits" (8 April 1988) at paras. 18 and 19:

the employer if it was taken during normal working hours and the employee was given time off with pay to attend the course.⁴⁵ Then, the Revenue Agency took the position that courses leading to a university degree could never be taken primarily for the benefit of the employer since the degree was a personal asset of the employee.⁴⁶ In a letter dealing specifically with the attainment of an MBA degree, the Revenue Agency stated that:

Courses that lead to degrees or professional designations are normally viewed as career enhancing studies of primary benefit to the student, even though the employer obviously also benefits during the student's period of employment with that employer. In our view an MBA Program is of primary benefit to the student, as it represents a means of enhancing one's chances of a promotion in the short term or enhancing one's overall career opportunities in the long run.⁴⁷

In support of this position, the Revenue Agency won a series of cases in the 1990s holding that employees had to include in their income the value of the tuition paid by their employers for courses to obtain a Certified General Accountant designation,⁴⁸ to complete an MBA,⁴⁹ and to qualify as a clinical child psychologist.⁵⁰

In early 1998, the Revenue Agency's assessing practice for courses leading to a university degree became front page news when an employee of Ipsco Inc., a Regina steel company, contested a \$30,000 assessment he received from the Revenue Agency that included in his income the value of a two-year MBA taken at his employer's expense. Ipsco Inc. waged a public battle against the assessment, expressing concern

18. Where an employer has paid tuition fees on behalf of an employee or has reimbursed an employee, in whole or in part, for tuition fees paid by the employee personally, the amount paid should be reported as income of the employee for the year in which the payment was made.

19. An exception to this rule can be made where the course for which the fees were paid was undertaken on the employer's initiative and for the benefit of the employer rather than the employee. This is usually presumed where a course is taken during normal working hours with the employee being given time off with pay for that purpose. On the other hand, if the course is taken on the employee's own time, the presumption is that the course is primarily for the employee's benefit and the amount paid by the employer is a taxable benefit to the employee.

⁴⁵ *Ibid.* at para. 19. Several letters issued by the Revenue Agency also noted that if the training was taken to improve the employee's chance of promotion or to prepare for an alternate job, those courses were not considered to be taken primarily for the benefit of the employer. See e.g. Revenue Canada, Memo 9208085, "Tuition Fee Reimbursement" (15 April 1992); Revenue Canada, Memo 9507635, "Taxable Benefits" (29 June 1995).

⁴⁶ See e.g. Revenue Canada, Memo 9507635, *ibid.*

⁴⁷ Revenue Canada, Memo 9609415, "Employee Benefits and Tuition" (25 April 1996). For similar reasoning, see Revenue Canada, Memo 9521155, "Tuition Fee Reimbursement" (19 October 1995).

⁴⁸ See *Faubert v. Canada (M.N.R.)* (1998), 98 D.T.C. 1380, [1998] T.C.J. No. 21 (QL).

⁴⁹ See *Sami v. Canada (M.N.R.)*, [1995] 2 C.T.C. (N.S.) 2915, 10 C.C.P.B. 10 (T.C.C.).

⁵⁰ See *Yaholnitsky-Smith v. Canada (M.N.R.)*, [1991] T.C.J. No. 1125 (QL) (T.C.C.).

about the implications of the ruling for Canada's competitive position in the world economy and enlisting the support of members of the federal cabinet, including then Industry Minister John Manley.⁵¹ Briefs and letters objecting to the assessment by associations such as the Tax Executives Institute and the Canadian Council of Chief Executives were released to the public.⁵² Business newspapers across the country picked up the story. Headlines included "Income Tax on Courses Criticized", "Revenue Canada Goes after Workers Upgrading Education", and "Tax on Training Misses the Point".⁵³

Within weeks after the beginning of the publicity campaign, the Revenue Agency relented. To curb the flood of bad publicity, it initially released a letter on 11 March 1998, stating that the treatment of education benefits was being reviewed.⁵⁴ Two months later, it published a technical news release stating that it had changed its position on the taxation of employer-paid education and offering the following justification:

[C]onsultations have shown that in our current environment, with rapidly changing technology and a quickly expanding global market, it is necessary for most individuals to constantly upgrade their knowledge and skills in order to remain productive. Employers consider it to be an absolute necessity to encourage and support training of their employees at all organization levels. They have also advised that most employer-paid training is directly related to job responsibilities; however, some training is clearly for the principal benefit of the employee.⁵⁵

The Revenue Agency's revised position was that, "[w]hen the training is taken primarily for the benefit of the employer there is no taxable benefit, whether or not

⁵¹ For details of the story, see Arthur Drache, "Revenue Eases Rules on Training Courses" *The Financial Post* (16 June 1998) 32; see also Shawn McCarthy, "Ottawa to Relent on Training Taxes: Rules to Be Issued Today Would Save Employees from Being Taxed for Work-Related Courses" *The Globe and Mail* (7 May 1998) B9.

⁵² "Employer Payment or Reimbursement of Training Costs Under the Canadian Income Tax Act" (May-June 1998), online: Tax Executives Institute <<http://www.tei.org/pubs.html>>; David Stewart-Patterson, "Stealth Tax on Training Must Stop: Revenue Canada's Slant on Learning Threatens Millions with Retroactive Tax for Gaining Knowledge at Employer's Expense" (February 1998), online: The Canadian Council of Chief Executives <<http://www.bccni.com/english/publications/opinions/feb98.htm>>.

⁵³ See "Income Tax on Courses Criticized" *The Toronto Star* (19 February 1998) D10; Sandra Cordon, "Tax on Training Provokes Anger: Revenue Canada Goes after Workers Upgrading Education" *Winnipeg Free Press* (19 February 1998) B6; "Tax on Training Misses the Point," Editorial, *The Financial Post* (27 February 1998) 14; Kathryn May, "Ipsco Tilts at Taxman over Rnling on Training" *Hamilton Spectator* (20 February 1998) D10; Elizabeth Church, Shawn McCarthy & Gordon Pitts, "Tax Issue Poses Tough Question" *The Globe and Mail* (19 February 1998) B14.

⁵⁴ Revenue Canada, Memo 9805328, "Employer-Paid Tuition" (11 March 1998).

⁵⁵ Revenue Canada, Income Tax Technical News No. 13 (7 May 1998).

this training leads to a degree, diploma or certificate.”⁵⁶ In elaborating upon training that would be regarded as taken primarily for the benefit of the employer, the Revenue Agency stated that:

Courses which are taken for maintenance or upgrading of employer-related skills, when it is reasonable to assume that the employee will resume his or her employment for a reasonable period of time after completion of the courses, will generally be considered to primarily benefit the employer and therefore be non-taxable. For example, fees and other associated costs such as meals, travel and accommodation which are paid for courses leading to a degree, diploma or certificate, in a field related to the employee’s current or potential future responsibilities in the employer’s business, will not result in a taxable benefit.⁵⁷

Numerous letters from the Revenue Agency to individual taxpayers have subsequently confirmed that not only MBAs but also other university degrees normally will not be regarded as taxable benefits when paid for by employers.⁵⁸ In one illustrative letter, an employer asked about the tax consequences of hiring students out of high school and offering to pay for their university courses provided the students work for the employer in their summers and for some period of time after completing their university degrees. In response to the query, the Revenue Agency replied, “Since these employees are being trained for specific jobs in the employer’s organization, the benefits resulting from this arrangement would not be considered taxable.”⁵⁹

In addition to a variety of letters, the Revenue Agency has published at least one ruling on this issue.⁶⁰ The employees of the company applying for the ruling could take university courses including courses in computers, psychology, sociology, management, economics, art/design, English or French literature, languages, and accounting. The employees were required to continue to work an average number of hours a week for the employer, and the education could not consist of programs that would simply permit the employees to meet the minimum education requirement for a specific employment position at the company or to permit the employees to qualify for an employment position that was not available at the employer. The stated purpose of the education plan was to encourage employees to further their education, skills, and abilities as they relate to their current or future employment responsibilities and to

⁵⁶ *Ibid.*

⁵⁷ See Revenue Canada, Interpretation Bulletin IT-470R (consolidated), “Employees’ Fringe Benefits” (12 October 1999) at para. 18 [IT-470R].

⁵⁸ See *e.g.* Canada Customs and Revenue Agency, Memo 2000-0043607, “Employer-Paid Tuition” (17 November 2000).

⁵⁹ Revenue Canada, Memo 9903137, “Employer Paid University” (11 March 1999). For a similar opinion, see Revenue Canada, Memo 9910065, “Employer-Paid Education Costs” (29 July 1999).

⁶⁰ Canada Customs and Revenue Agency, Ruling 2001-0068203, “Taxable Benefits” (18 August 2001).

ensure that the employer had a well-educated and productive workforce. The Revenue Agency ruled that these programs could be provided to employees tax-free.⁶¹

The Revenue Agency's new policy that employer-provided payments for courses leading to a university degree are not a taxable benefit violates almost all of the guidelines of an equitable, efficient, and administratively practicable fringe benefits policy. A sensible approach to the issue appears to have been derailed because of the Revenue Agency's reliance on the test of whether the education obtained by an employee was for the employer's benefit. As explained above, this is always an inappropriate test for the taxation of fringe benefits. The central question is not whether the employer benefits from the provision of the services, but whether the employee derives a personal benefit. In the case of university courses leading to a degree, personal benefits are always present.

The Revenue Agency's policy also creates numerous inequities. Most obviously, it is unfair to those who are not able to negotiate to have their employers pay for their university education. A university education is acquired by a substantial number of employees in many industries and by all employees in many professions, yet this will be a benefit that will undoubtedly be provided only to a small, select number of employees. It is also unfair to those who acquire their university education before they start working and thus do not have an opportunity to have an employer pay for their expenses.

Moreover, the policy creates numerous perverse incentives. Since the benefit is potentially so large, there appears to be little doubt that it will give rise to changes in compensation packages. Employees who are in a position to take advantage of this in-kind benefit often will be in a position to negotiate individual employment contracts. In addition, permitting the nontaxed provision of a university education will encourage students to enter the workforce before entering post-secondary education. To the extent that some university courses and degrees are more likely to be held to be for an employer's benefit, it will encourage students to enrol in employment-related courses and discourage them from taking courses that provide them with a more general liberal education. Faculties may be encouraged to remove the liberal education component from their programs to ensure that these programs qualify as tax-free when paid for by employers. Since fees for many professional courses in universities are now deregulated, providing this large subsidy for the fees will also contribute to the upward pressure on fees, making it more difficult for unsubsidized students to enter the programs. Finally, it will be difficult, if not impossible, for the Revenue Agency to sensibly draw lines between those university courses and

⁶¹ Note that if the employer reimburses the employee for the education expenses, that reimbursement must be within a reasonably short time period after the course is taken. See Canada Customs and Revenue Agency, Memo 2002-0146705, "Reimbursement of Tuition" (13 September 2002).

programs enrolled in by employees that can be said to be for the benefit of employers and those that cannot.

The business interests that objected to the Revenue Agency's initial policy that employer-provided assistance for courses leading to a university degree was a taxable benefit were correct in arguing that the government should be doing as much as possible to assist workers in continually upgrading their skills and knowledge. However, the Revenue Agency's present policy in essence creates a government subsidy program to achieve that end, and it is hard to imagine a more inequitable and perverse educational program than the one now inherent in the nontaxation of employer-assisted university degrees.

B. Combined Employment-Related and Pleasure Trips

Employees frequently take trips that are paid for by their employers. In taking many of these trips, employees derive no personal benefit. An employer might require employees to take trips, for example, to meet with customers or suppliers or to attend business meetings. The employees' time in many cases is occupied fully during normal business hours at the destination, and they return home immediately after conducting their employer's business. Obviously, employees should not be taxed on the value of these trips. This is the case even though some employees might thoroughly enjoy spending a few days away from home conducting business, occasionally in what might otherwise be regarded as a vacation destination, and might spend their evenings enjoying the local tourist spots or visiting friends and relatives. There is no reason that these incidental personal benefits of discharging one's employment responsibilities should be treated any differently from the many other incidental benefits of employment. Of course, the Revenue Agency should be vigilant in ensuring that the personal benefits of nontaxable trips are only incidental to the employment-related purposes. In reading the cases in this area, one sometimes suspects that employers can be somewhat ingenious at disguising vacations as business trips.⁶²

Employers may also pay for trips for their employees that are intended to be solely for the employees' personal enjoyment. The full value of these trips should be included in the income of employees on the grounds of equity. These trips represent personal consumption for which most taxpayers have to pay out of their after-tax income. Indeed, these trips are often incentive or reward trips that will serve their purpose only if employees derive substantial personal pleasure from them. In addition, since most employees likely take vacations each year, the failure to tax the personal consumption component of employer-provided trips would likely result in

⁶² See e.g. *Arsens v. Canada (M.N.R.)* (1969), 69 D.T.C. 81, [1969] Tax A.B.C. (N.S.) 1; *Marossi v. Canada (M.N.R.)*, [1980] C.T.C. 2832 (T.R.B.); *McMillan v. Canada (M.N.R.)*, [1993] 2 C.T.C. 2489, [1993] T.C.J. No. 296 (QL) (T.C.C.).

free trips being substituted for cash salary. Under the present law⁶³ and administrative practice,⁶⁴ the value of these trips is taxed.

Occasionally, on trips that are intended primarily as rewards for employees, the employees might have to attend a few incidental business functions or otherwise engage in employment-related activities. The Revenue Agency has indicated that where this is the case, it will reduce the value of the trip that has to be included in the employees' income: "[T]he taxable benefit may be reduced if there is conclusive evidence to show that the employee was involved in business activities for the employer during the vacation."⁶⁵ This seems like an unnecessary concession. Even if an employee has to attend some employment-related functions while on a vacation, it is doubtful that those activities would detract from the personal value of the vacation.

The same rules that apply to an employee also apply to anyone who travels with the employee, typically a spouse, and who has his or her travel costs covered or subsidized by the employer. If the spouse is travelling primarily for personal reasons, then the value of the spouse's trip is included in the income of the employee. If, however, the spouse is primarily engaged in business activities on behalf of the employer, then his or her travel costs are not considered to be a taxable benefit to the

⁶³ See *Affetuso v. Canada (M.N.R.)*, [1981] C.T.C. 2450, 81 D.T.C. 389 (T.R.B.); *Stevens v. Canada (M.N.R.)*, [1993] 1 C.T.C. (N.S.) 2429, 93 D.T.C. 291 (T.C.C.).

⁶⁴ Travel benefits are discussed in IT-470R, *supra* note 57, at paras. 7 (travel benefits), 10-12 (holiday trips) and 15 (travel expenses of employee's spouse). The detailed guidance on the taxation of trips set out in IT-470R and described *infra*, has developed significantly from the single paragraph originally included in Department of National Revenue, Information Bulletin No. 24, "Employees' Fringe Benefits" (12 February 1964) [1964 Information Bulletin]. Paragraph 5 on page 4 of that Bulletin simply stated, "A free holiday trip or a vacation with expenses paid given by an employer to an employee for long or meritorious service, or any prize, whether in cash or in kind, in recognition of job performance, constitutes a taxable benefit from the employment which should be measured by the cash equivalent."

Paragraph 7 of IT-470R sets out the general rule governing employee travel costs. It states that "[a]n amount received, or the value of a benefit received or enjoyed, by virtue of employment in respect of travelling expenses incurred by an employee, the employee's family or both is a taxable benefit ..." Paragraph 10 deals in particular with employer-provided vacations, stating, "[w]here an employer pays for a vacation for an employee, the employee's family or both, the cost thereof to the employer constitutes a taxable benefit to the employee under paragraph 6(1)(a)."

⁶⁵ IT-470R, *ibid.* at para. 10. Paragraph 12 of IT-470R addresses the situation where the employee acts as a host for an incentive award trip arranged for employees, suppliers, or customers. It states that "[s]uch a trip will be viewed as a business trip provided the employee is engaged directly in business activities during a substantial part of each day (e.g., as organizer of activities); otherwise it will be viewed as a vacation and a taxable benefit, subject, of course, to a reduction for any actual business activity." See also Revenue Canada, Memo 9905737, "Taxable Benefit, Trip Paid by Employer" (21 April 1999).

employee.⁶⁶ In several cases, employees have been able to have the value of their spouses' trip reduced because the spouses were expected to engage in some employment-related activities. Again, this seems to be an inappropriate concession. Even if spouses have to engage in some employment-related activities, it is doubtful that those activities would reduce the personal value of the trip to them. Indeed, this concession seems simply to provide an opportunity for employers to structure trips so that they do not give rise to a taxable benefit. Moreover, in this day and age, there seems to be something archaic about expecting an employee's spouse to attend employment-related activities to further his or her career.

The difficult cases involving employee travel arise when a trip has a dual purpose—partly business and partly personal. Take the simplest case. Assume that an employer pays for an employee's trip that requires a flight from Toronto to Vancouver and for all related travel expenses. The employee spends three full days attending to employment-related business affairs and then spends the next three days vacationing. How much of the costs, if any, should be included in the employee's income as a taxable in-kind benefit?

The case law in Canada is not consistent on this issue. In a number of early cases, the judges appeared quite willing to assess all of the facts and circumstances surrounding the trip and make an overall, ad hoc judgment about what percentage of the costs should be regarded as providing a personal benefit. For example, in *Philp v. Canada (M.N.R.)*,⁶⁷ the employees were managers of retail grocery stores. They were provided with trips to Nassau, where they spent six days. On three of those six days, they attended two-hour meetings. The Exchequer Court held that fifty per cent of the cost of the trip should be included in the employees' income as a fringe benefit. In *Ferguson v. Canada (M.N.R.)*,⁶⁸ the taxpayer was invited to Athens by a supplier to attend a sales convention at the supplier's expense. While in Athens, the employee had some free time and went on a few tours. The Tax Review Board held that ten per cent of the cost of the employee's trip should be included in income as an amount that reflected the personal benefit of a primarily business trip. In *Lewis v. Canada (M.N.R.)*,⁶⁹ the taxpayer received a trip to Nassau as a prize in a sales contest. Based on very few reported facts, the value of the benefit was apportioned. Two-thirds of the value of the trip was taxed, and one-third of the value of the trip, which was held to be

⁶⁶ Paragraph 15 of IT-470R, *ibid.*, adds that, “[w]here a spouse accompanies an employee on a business trip the payment or reimbursement by the employer of the spouse's travelling expenses is a taxable benefit to the employee unless the spouse was, in fact, engaged primarily in business activities on behalf of the employer during the trip.” See also Canada Customs and Revenue Agency, Memo 2002-0134225, “Employee's Spouse Travel Benefits” (8 May 2002). See also *Hale v. Canada (M.N.R.)*, [1969] 1 Ex. C.R. 259, [1968] C.T.C. 477; *Waffle v. Canada (M.N.R.)*, [1969] 1 Ex. C.R. 384, [1968] C.T.C. 572; *Paton v. Canada (M.N.R.)* (1968), 68 D.T.C. 197 (T.A.B.).

⁶⁷ [1970] Ex. C.R. 496, [1970] C.T.C. 330 [*Philp*].

⁶⁸ (1972), 72 D.T.C. 1097 (T.R.B.).

⁶⁹ (1970), 71 D.T.C. 4 (T.A.B.).

business, was not. In *Hart v. Canada (M.N.R.)*,⁷⁰ the employee of a farm operation took a trip that included examining various agricultural operations in Australia and New Zealand. The Federal Court, Trial Division, decided that the trip was one that combined business and pleasure and allocated the costs of the trip half to business (nontaxable) and half to pleasure (taxable). This allocation was accepted by the Federal Court of Appeal.

A comparison of three cases (all decided under the informal procedure) decided on similar facts provides a particularly good example of the arbitrariness of an ad hoc allocation rule. In *McMillan v. Canada (M.N.R.)*,⁷¹ *Dagenais v. Canada (M.N.R.)*,⁷² and *Cales v. Canada (M.N.R.)*,⁷³ the employees, who were employed at Oliver Industrial Supply Ltd., were provided with free trips to Fiji and Mexico by their employer. The employees argued that they should not be taxed on the value of the benefit because the supplier who provided the trip did not employ them and because the trip was a business trip. The employees did discuss some business on these trips, but no formal meetings were held. In *McMillan*, the court found that the trip was a taxable benefit and required inclusion in income of forty per cent of the cost of the trip. In contrast, in *Cales* and *Dagenais* the court found the benefit was taxable remuneration and valued the personal component of the trip at eighty-five per cent of its cost.

Instead of using an apportionment approach similar to that applied by the courts where a trip has both business and personal aspects, the Revenue Agency takes the position that if the main purpose of the trip is business, then no taxable benefit arises.⁷⁴ The Federal Court of Appeal endorsed this principal purpose test in its most recent decision on travelling benefits. In *Lowe v. Canada (M.N.R.)*,⁷⁵ the employee's company was rewarding brokers who obtained new insurance business and sent the taxpayer and his wife on the reward trip to New Orleans. In reassessing the employee, the Minister allocated the cost of the trip between business and pleasure determining, based on evidence about the events that took place throughout the trip, that thirty-eight per cent of the employee's cost could be allocated to business. The Tax Court of Canada accepted the apportionment model, but found that only twenty per cent of the cost of the employee's trip was personal. In contrast, the Federal Court of Appeal found that the employee did not receive anything of value in an economic sense. The

⁷⁰ [1981] C.T.C. 91, 81 D.T.C. 5070 (F.C.T.D.), aff'd [1982] C.T.C. 275, 82 D.T.C. 6237 (F.C.A.) [*Hart*].

⁷¹ (1995), 9 C.C.P.B. 213, [1995] T.C.J. No. 281 (Q.L.) (T.C.C.) [*McMillan*].

⁷² (1995), 7 C.C.P.B. 59, [1995] T.C.J. No. 20 (Q.L.) (T.C.C.) [*Dagenais*].

⁷³ (1995), 7 C.C.P.B. 96, [1995] T.C.J. No. 19 (Q.L.) (T.C.C.) [*Cales*].

⁷⁴ IT-470R, *supra* note 57 at para. 11 provides, "In a situation where an employee's presence is required for business purposes and this function is the main purpose of the trip, no benefit will be associated with the employee's travelling expenses necessary to accomplish the business objectives of the trip if the expenditures are reasonable in relation to the business function."

⁷⁵ [1996] 2 C.T.C. 33, 96 D.T.C. 6226 (F.C.A.).

court came to this conclusion by applying a principal purpose test, finding that the principal purpose of the trip was business, not pleasure. The Federal Court noted in its reasoning that its approach was consistent with the Revenue Agency's position.⁷⁶

The Revenue Agency's position that a trip with business as its main purpose is not taxable is not entirely unqualified. If an employee extends a trip that has business as its main purpose "to provide for a paid holiday or vacation, the employee is in receipt of a taxable benefit equal to the costs borne by employer with respect to that extension."⁷⁷ However, in these circumstances, the employee is not required to pay tax on the value of the associated travelling expenses, for example, the airfare costs of getting to the destination in the first place.

The principal purpose test is much too lenient with respect to these types of dual-purpose trips. There is no reason for believing that an employee who travels mainly for business receives no personal benefit whatsoever, or that an employee who is able to attach a vacation to an employment-related business trip does not receive significant benefits from the travel expenses incurred in getting to the destination. Indeed, it could be argued that where an employee enjoys a vacation after conducting employment-related activities at a particular destination, the full value of the airfare incurred in travelling to the destination should be included in the employee's income. The fact that the employee takes a vacation at the location is a clear indication that she personally values being there. However, an apportionment rule, although arbitrary, would compensate for the fact that most people would not pay the full fair market value of a flight to a destination they could not freely choose.

A sensible apportionment rule for the travel expenses would be based upon easily verifiable facts, for example, by comparing the number of days that the employee spent on employment-related activities with the number of days she spent on vacation-related activities. Of course, this approach would require a number of detailed, arbitrary rules and assumptions. For example, what if instead of three clear employment-related days and three clear vacation-related days, the employee spent each day partly on employment activities and partly on personal activities? A simple solution would be to count the number of hours each day spent on business and then to provide that for the purposes of the apportionment rule, seven hours equals one business day. Thus, if an employee travelled from Toronto to Vancouver for five days and spent fourteen hours on employment-related activities, two-fifths of the days would count as business and three-fifths as personal. Such a rule may lead to arbitrary results. For example, what if the employment activities occupied only two hours of each day, but extended over a number of days, and the employee was not enjoying a vacation, but was simply waiting for the next series of meetings? Or what if the

⁷⁶ See also the earlier appeal level cases, which were decided based on an allocation: *Hart*, *supra* note 70, and *Philp*, *supra* note 67.

⁷⁷ IT-470R, *supra* note 57 at para. 11.

employee spends an additional day in Vancouver at the employer's request to receive a reduction in the cost of the airfare? Again, an arbitrary rule might be developed—if an employee stays an additional day to obtain a cheaper flight, such a day would count as a business day.⁷⁸

Combined employment-related and pleasure trips would appear to be an area where there is a need for detailed, arbitrary rules to carve out the personal benefit that employees derive from such trips. The rules will undoubtedly lead to some inequitable results; however, overall, the results would be a good deal more predictable and consistently applied than the present ad hoc apportionment rules and would likely lead to more equitable results than the principal purpose test.

C. Clothing

Because everyone must wear clothes, there is an obvious personal expense. However, some jobs have particular clothing requirements that have caused tax authorities difficulty in determining whether or not the employee should be taxed when an employer provides those clothes. For example, some employees are required to wear protective clothing; many employees are required to wear uniforms; countless employees are required to sport the clothing manufactured or sold by their employers; and other employees are required to dress professionally in outfits that are more expensive than they would otherwise purchase. If an employer provides these kinds of clothing for employees, should the employee be required to pay tax on the value of the clothes?

Under the current law, as a general rule, where an employer provides an employee with clothing, the employee is taxed on its value. There would appear to be three exceptions to this general rule. First, where employees are provided with special clothing designed for protection, they will not be subject to tax. Second, where employees are provided with distinctive uniforms, they will not be subject to tax. These two exceptions are clearly set out in the Revenue Agency's fringe benefits interpretation bulletin:

An employee who is supplied with a distinctive uniform which is required to be worn while carrying out the duties of employment or who is provided with special clothing (including safety footwear) designed for protection from the particular hazards of the employment, is not regarded as receiving a taxable benefit.⁷⁹

⁷⁸ See Revenue Canada, Memo 9302375, "Extended Travel on Employer's Business" (15 June 1993), where the Revenue Agency takes the position that the additional costs associated with the Saturday stay may be deducted, but confirms that whether the benefit is taxable to the employee is a question of fact to be determined in the circumstances.

⁷⁹ IT-470R, *supra* note 57 at para. 29. Paragraph 30 deals with dry cleaning and permits an employer to pay for the dry cleaning or other laundering of tax-exempt uniforms and special clothing

Third, where employees are required to wear particular clothing while performing their duties and are unable to wear that clothing outside of the work environment, it is possible that they will not be subject to tax when the employer provides that clothing. This third exception was created by courts: for example, the supply of “plain clothes” by a police department to police officers was held not to constitute a taxable benefit to the recipient employees.⁸⁰ In a letter to the RCMP, responding to its request for permission to provide tax-free plain clothes to its undercover police, the Revenue Agency stated that to come within the third exception, the RCMP would have to “meet the same factual situation” as the undercover police in the most recent case on the issue, *Huffman*. The letter describes the facts in *Huffman* as follows,

In the performance of his duties, Mr. Huffman had to investigate industrial accidents, drownings, fires, cave-ins and bodies found in fields and ditches, including examining for fingerprints, footprints, blood stains and other physical evidence. His clothes often became soiled, torn or contaminated with odours, requiring frequent cleaning. It was necessary for him to wear a larger, looser fitting jacket to accommodate the equipment he was required to carry (notebook, badge and identification folder, billy club, pager, walkie talkie, handcuffs and revolver, in a shoulder or waist holster).⁸¹

The general rule that employees should be taxed on the value of clothing provided by their employers is appropriate. Where an employer provides employees with either regular clothing or clothing that is similar to clothing that would be worn regularly, but which is more expensive than employees would generally purchase (e.g., suits worn by business people or professional clothing for teachers) employees should be required to include the fair market value of the clothing in their incomes. Failing to tax this kind of clothing would result in inequities since clothing would undoubtedly only be provided to some employees. Although an employee might argue that she would not purchase a suit in the absence of the employment, the provision of the suit does relieve the employee of a personal expense. Although the clothing might be more expensive than what the employee would normally wear, many people still

without tax consequences to employees. The Agency’s administrative position has been elaborated upon in letters written in response to particular taxpayers, which take *Huffman* into consideration (see *infra* note 80). See e.g. Revenue Canada, Memo 9801325, “Employer-Provided Clothing” (6 April 1998). See also Revenue Canada, Memo 9415455, “Employment Benefits—Special Clothing” (26 July 1994); Revenue Canada, Memo 9309165, “Clothing” (10 June 1993).

The Revenue Agency’s position on clothing has not changed since the 1964 Information Bulletin, *supra* note 64, which stated at paragraph 4 that “[w]here an employee is supplied with a distinctive uniform which he is required to wear while carrying out the duties of his employment or where he is provided with special clothing designed to protect him from the peculiar hazards of the employment, he is not regarded as getting a taxable benefit therefrom.”

⁸⁰ See *Shoveller v. Canada (M.N.R.)*, [1984] C.T.C. 2207, 84 D.T.C. 1195 (T.C.C.); *Huffman v. Canada (M.N.R.)* (1990), 71 D.L.R. (4th) 385, [1990] 2 C.T.C. 132 (F.C.A.) [*Huffman*].

⁸¹ Revenue Canada, Memo 1991-157, “Plainclothes Allowance, Kit Upkeep Allowance for the Royal Canadian Mounted Police” (16 September 1991).

value that clothing. If an employer were able to provide some types of clothing tax-free to employees, there would be a substantial incentive to change compensation packages to provide clothing in lieu of cash.⁸²

The first two exceptions from the taxation of employer-provided clothing mentioned above—the provision of special clothing for protection and the provision of distinctive uniforms—are also appropriate.⁸³ Protective clothing provided by employers is analogous to providing employees with the equipment required to do their job: for example, asbestos suits for those who work close to furnaces and space suits for astronauts. This type of clothing provides employees with little personal benefit and is unlikely to substitute in any significant way for personal clothing that they would otherwise purchase. Moreover, it does not make sense to design a rule that would discourage employers from providing employees with this kind of clothing.

Distinctive uniforms to employees—for example, workout clothing for aerobics instructors, promotional shirts for servers, white uniforms for nurses, animal outfits for mascots, and police uniforms for police officers—should also be exempt from tax, but the case is not as obvious. On the one hand, as a result of the provision of a uniform, employees are relieved from the expense of purchasing clothing that they would have to wear at work and from the expense of wear and tear on their after-work clothes. On the other hand, the horizontal inequities are not great since all employees in particular industries likely either receive uniforms or not. Further, it is unlikely that the tax-free provision of uniforms will cause vertical inequities. Uniforms are not likely to be provided primarily to high-income employees. Also, presumably few people would bargain to receive uniforms as part of their compensation package, so the inefficiencies created by the nontaxation of employer-provided uniforms are unlikely to be serious. The administrative problems caused by this exemption are not severe since the category of clothing to which it applies is not hard to define. Finally, if the provision of uniforms were taxed, in some cases it would be difficult to determine the value of the uniform.

To ensure that the exemption for uniforms is not abused, however, strict rules for its application should be developed and enforced. First, some aspect of the job should require the clothing. Second, it should be a condition of employment that the uniform cannot be worn outside of the workplace.⁸⁴ Third, the uniform should be provided to all employees of the particular group (in other words, in a non-discriminatory

⁸² Some commentators have argued that it might be reasonable for lawyers and accountants to receive business suits tax-free from employers. See e.g. Vern Krishna, "Be Prepared to Pay Tax on Your Perks as Well as Your Pay" *The Globe and Mail* (16 September 2002) B10.

⁸³ The distinctive uniform exception was supported by Canada, Douglas J. Sherbaniuk, *Studies of the Royal Commission on Taxation: Specific Types of Personal Income*, no. 16 (Ottawa: Queen's Printer, 1967) at 69.

⁸⁴ The Canada Customs and Revenue Agency contemplates these requirements in some of its letters. See e.g. Revenue Canada, Memo 9801325, "Employer-Provided Clothing" (6 April 1998).

fashion). Finally, it should be identifiable as a uniform—either because it would not be possible to wear it outside of the employment place (e.g., it is a gym outfit for a fitness instructor or a mascot uniform) or because it is printed with an obvious logo. Where the “uniform” is simply a particular style or colour of pants and shirt, but without any other identifying features, the outfit should not qualify for the exception.⁸⁵

Finally, the third exception, which permits clothing to be received tax-free if it is required by the taxpayer’s employment and cannot be worn outside the work environment, should be abandoned. The only possible explanation for this exception is that the courts felt some special disposition towards plainclothes police officers. All sorts of employees, particularly employees in agricultural and construction industries, have to wear special work clothes that have features that make them inappropriate to wear after work and that tend to wear out quickly. There is no obvious bright line that distinguishes these clothes from the clothes worn by undercover police officers.

D. Subsidized Parking

As a component of their commuting cost, employees who drive to work often need to pay for parking. In most cities, the cost of parking can be substantial; for example, in the City of Toronto, a parking pass in the downtown core can cost up to \$500 a month.⁸⁶ Moreover, it may be difficult for employees to find convenient

⁸⁵ The Australian government has grappled with this issue in the context of whether the cost of corporate uniforms can be deducted under subsection 51(1) of the *Income Tax Assessment Act 1936*. In determining whether the uniform cost is deductible, the tax administration will look at a variety of factors, including whether the objective of the uniform is to enhance the public image of the employer and to act as an indirect form of advertising, whether the clothing may only be worn on official duty, whether the uniform has a distinctive and unique look, whether the uniform is readily identifiable as belonging to a corporate uniform, whether the number of colours and fabrics in the uniforms are limited, whether there are only a limited number of styles of the uniforms, whether there are readily identifiable logos, and whether the uniform is intended to last for a number of years. See e.g. Australian Taxation Office, Income Tax Ruling IT 26/41, “Income Tax: Corporate Wardrobes and Corporate Uniforms” (27 June 1991).

⁸⁶ As reported in *The Financial Post*,

One of the most common perks enjoyed by executives is the coveted parking space. This seems like a freebie for the executives, but the Canada Customs and Revenue Agency believes otherwise. The taxman has long believed parking provided by a company constitutes a taxable benefit to the worker. The amount of this benefit is based on the going rate for the space. And that rate can be quite high, especially in Canada’s biggest cities. For example, a reserved underground space in Toronto’s BCE Place approaches \$500 a month. Multiply that by 12 months and the employee is facing a taxable benefit of close to \$6,000 a year, which, at the top marginal tax rate, would cost him close to \$3,000 in tax (Jamie Golombek, “Hey Mr. Taxman, Stay Away from My Parking Space” *The Financial Post* (24 February 2001) C6).

parking close to their place of employment. For these reasons, employers frequently provide employees with free or subsidized parking.

As a general rule, employer-subsidized parking is treated as a taxable benefit and employees are required to include its fair market value in their income.⁸⁷ Indeed, employees will be held to have had a benefit conferred on them whether or not the parking spot is used. In *Richmond v. Canada (M.N.R.)*, the taxpayer's employer provided him with a parking spot, but as the employee lived close to the office, he generally chose to walk to work; nevertheless, the court held that he had received a taxable benefit.⁸⁸ The value of the benefit was the value of parking in downtown lots similar to the lot available to the employee. Although the fair market value of the parking spot has been adopted in most cases as the appropriate value of the benefit, in a recent case, the Tax Court of Canada deviated from this valuation method. In *Stauffer v. Canada (M.N.R.)*,⁸⁹ the taxpayers were employees of the federal government who received reduced-rate parking at the University of Saskatchewan. The court accepted the cost of the parking to the employer as the value of the benefit to the employees—instead of the fair market value of the parking spaces.

There are at least three exceptions to the general rule that employer-provided parking is a taxable benefit. First, employees are not subject to tax where they have to "scramble park". In other words, if an employer has more employees who are given a right to a parking space than it has parking spaces (so employees have to scramble for the parking spaces), the employees are not subject to tax on the value of the spots they

⁸⁷ For example, the Tax Court of Canada held in *Monteith* that where a taxpayer was provided with a reserved spot, the fair market value of the spot must be included in the taxpayer's income: *Monteith v. Canada (M.N.R.)*, [1998] 2 C.T.C. 2281, 98 D.T.C. 1306 (T.C.C.) (informal procedure). Free parking is not addressed in the Canada Customs and Revenue Agency's Interpretation Bulletin. Instead, the parking policy is set out in the Canada Customs and Revenue Agency's "Employers' Guide—Taxable Benefits (2001-2002)" at para. 2.16 ["Taxable Benefits"]:

Employer-provided parking generally constitutes a taxable benefit to the employee, whether or not the employer owns the lot. The amount of the benefit is based on the fair market value of the parking *minus* any payment the employee makes to use the space. . . . If you cannot determine the fair market value, do not add a benefit to the employee's remuneration. This could happen in the following situations: a business operates from a shopping centre or industrial park, where parking is available to both employees and non-employees; or an employer provides *scramble* parking (i.e., there are fewer spaces than there are employees who require parking, and the spaces are available on a first-come, first-served basis) [emphasis in original].

⁸⁸ [1998] 3 C.T.C. 2552, 98 D.T.C. 1804 (T.C.C.) (informal procedure). Almost all of the cases on parking benefits have been decided under the informal procedure, and they are therefore not binding decisions. The only exception is *Saskatchewan Telecommunications v. Canada (M.N.R.)* (1999), 99 D.T.C. 1306, 22 C.C.P.B. 74 (T.C.C.) [*Saskatchewan Telecommunications*].

⁸⁹ [2002] 4 C.T.C. 2608, [2002] T.C.J. No. 494 (QL) (T.C.C.) (informal procedure).

use.⁹⁰ Second, employees are not subject to tax where the fair market value of the spot cannot be determined.⁹¹ Third, employees are not required to pay tax on the value of a parking spot if they are regularly required to use their vehicles for employment-related purposes.⁹² The Revenue Agency recognizes the above three exceptions to the general rule that employer-provided parking is a taxable benefit.

In a recent Tax Court of Canada case, a fourth exception might have been created. In *Chow v. Canada (M.N.R.)*,⁹³ the employer provided its employees with free parking on a first-come, first-served basis because they were required to work either rather early (beginning at 5 a.m.) or rather late (ending at 8 p.m.). If the employees did not drive their cars, the employer reimbursed the employees for taxi expenses. The court held that the parking was not a taxable benefit to the employees because the employer was able to save taxi costs when employees brought their own cars and parked them.⁹⁴ In a response to this case, the Revenue Agency noted that “it was heard under the informal procedure and the decision was based on specific facts. We feel that this decision will be limited in its application because of the particular facts.”⁹⁵

Commuting costs—such as the depreciation of the commuting vehicle, the cost of fuel, vehicle insurance, and vehicle repairs—are personal expenses since they originate in the personal decisions of employees to live at a distance from their place of employment. Parking expenses are no different from other costs of commuting. The inequities created by not taxing parking benefits are particularly serious since the benefits are easily provided to only some groups of employees—for example, executives and other high-income employees. In addition, but just as importantly, not taxing parking benefits can create perverse incentives. The true cost of driving to work is not reflected in the cost of automobiles, gas, parking, and other costs related to commuting. Driving in most large cities generates large social costs, such as increased pollution and traffic congestion. Instead of receiving an implicit subsidy, employees who drive to work should bear an additional tax cost to compensate for these external costs of their commuting.

⁹⁰ Only a few of the Revenue Agency’s letters address the meaning of “scramble parking”. In the Revenue Agency’s view, where “the number of people working per shift is close to the total parking spots available . . . [and] it is likely that not all employees would bring their cars” the parking will not be scramble parking: Canada Customs and Revenue Agency, Memo 2000-0022565, “Scramble Parking” (6 October 2000).

⁹¹ “Taxable Benefits”, *supra* note 87.

⁹² *Saskatchewan Telecommunications*, *supra* note 88.

⁹³ [2001] 1 C.T.C. 2741, 2001 D.T.C. 164 (T.C.C.) (informal procedure).

⁹⁴ Canada Customs and Revenue Agency, Income Tax Technical News No. 22, “Employee Benefits” (11 January 2002).

⁹⁵ *Ibid.* While the value of the case may be limited because it has no precedential weight, it does not appear that the fact pattern itself is particularly restrictive. In fact, many employers could likely argue that providing free parking “primarily benefits” the employer, particularly where the employer would otherwise pay for taxis.

In light of these compelling reasons for taxing parking privileges, there should be no exceptions to the general rule that parking benefits provided to employees are taxed at their fair market value. The scramble parking exception is presumably justified on the grounds either that it is difficult to determine the value of the benefit to all employees (what is the value of a parking spot you may only be able to obtain sometimes?) or that it is difficult to track which employees actually receive the benefit. These justifications are not persuasive. Employees who receive a parking spot, even if they have to scramble to get it, still receive a benefit. The Revenue Agency could easily require employers to keep track of who actually parks in the lot each day. If this solution were perceived to be too administratively burdensome, employees could be taxed in proportion to the number of employees who potentially use the space. In other words, if there are one hundred employees who commute using vehicles and there are only fifty parking spaces available, the Revenue Agency could require employees to be taxed as though they received a parking spot every other day.

It is hard to imagine the circumstances in which the second exception—which applies where the fair market value of the spot cannot be determined—might be appropriate. In most cases, parking lots are plentiful and comparative parking prices are easily obtained. Furthermore, even if determining the fair market value is difficult because there are no comparable parking lots, almost any reasonable estimate of value would be closer to the real value than the assumption that the parking privileges have no value. Of course, if the employer were providing employees with parking that would otherwise be free—which could conceivably be the case at a remote industrial location or a small town where the parking is available to everyone free of charge—and if providing space for parking had no opportunity cost to the employer, it would have no fair market value, or the value would be so small that as an administrative matter it should be ignored. In all other cases, the employer should have to make a reasonable estimate of the value of free parking provided to employees.

The employment-related purpose exception is also unjustified. This exception could be based on only two possible grounds. First, it might be justified on the basis that if employees have to use their automobiles during working hours for employment-related purposes, they derive no personal benefit from having parking privileges. Second, it could be said that the personal benefit of receiving a parking spot is diminished to a nominal amount for employees who are required to use their vehicles during their employment since they have no choice as to whether to commute to work and as to where to park. They must bring their cars to work, and they must park close to their employer's place of business. However, neither of these justifications is credible. Commuting costs, including the costs of parking, are personal because employees who commute are assumed to have made a personal decision to live at a distance from their place of employment. The fact that they are required to drive their cars to work for employment-related purposes does not change the personal nature of the commuting expenses. Also, the involuntary nature of the vehicle use does not mean that the employees do not value the spot at its fair market value.

E. Trips Taken with Frequent Flyer Points

Many employees are required to travel by air as part of their employment—to participate in meetings, attend conferences, or market their employer's goods and services. These employees are often members of frequent flyer plans that provide travellers with points for each trip taken. The points may be based on miles travelled, dollars spent, or a combination of the two. Employees hold the memberships in these plans as individuals (in fact, airlines do not permit employers to hold plans in the name of the company). Eventually, employees are able to cash in their accumulated points and receive free flights or other awards.

Taxing authorities have had difficulty determining how to tax frequent flyer points earned on business travel. Many jurisdictions have abandoned their attempts to tax these benefits in the face of perceived administrative and political pressures.⁹⁶ In the United States, the Internal Revenue Service struggled with the difficulty of developing and enforcing measures for taxing business-travel earned frequent flyer flights,⁹⁷ and recently announced that it plans to stop trying.⁹⁸ In Australia, the Tax Commissioner initially ruled that employees were required to include in income the value of a free flight taken on points accrued as a result of work-related travel.⁹⁹ However, the Federal Court subsequently held that such benefits were not granted in respect of the employee's employment and, therefore, were not taxable income.¹⁰⁰

In Canada, the Revenue Agency has always insisted that the fair market value of the airline tickets received for cashing in points accumulated while travelling on

⁹⁶ Taxing employees on the value of flights taken by cashing in business-earned frequent flyer miles is unpopular. *Giffen v. Canada (M.N.R.)*, [1995] 2 C.T.C. 2767, 96 D.T.C. 1011 (T.C.C.) [*Giffen*], a case on the taxation of frequent flyer points when redeemed, must be one of only a few Tax Court of Canada cases to be reported on CBC's *The National*. The focus of Ian Hanomansing's report on *The National* (CBC television broadcast, 29 April 1996) was Canadians' lack of awareness about the Revenue Agency's position, and the likelihood that most taxpayers do not actually report or pay tax on their benefits.

⁹⁷ See Kathy Krawczyk & Lorraine Wright, "How Should Frequent Flyer Miles Be Taxed?" (1998) 79 Tax Notes 1029. See also M. Bernard Aidinoff, "Frequent Flyer Bonuses: A Tax Compliance Dilemma" (1986) 31 Tax Notes 1345; Sharon Alice Pouzar, "Notes & Comments: Frequent Flyer Awards as Taxable Income: Time to Pay the Taxman" (1998) 5 Tex. Wesleyan L. Rev. 55. All of these commentators review the uncertainties surrounding the tax status of frequent flyer miles in the United States and urge clarification.

⁹⁸ See U.S., Internal Revenue Service, "Frequent Flyer Miles Attributable to Business or Official Travel" (Announcement 2002-18), which confirmed that frequent flyer points earned on business travel would not be subject to tax when cashed in for personal use.

⁹⁹ Australian Taxation Office, Tax Ruling TR93/2, "Income Tax and Fringe Benefits Tax: Benefits Received Under Frequent Flyer and Other Similar Consumer Award Type Programs" (7 January 1993). Now withdrawn.

¹⁰⁰ *Payne v. Australia (Commissioner of Taxation)* (1996), 66 F.C.R. 299, 96 A.T.C. 4407 (F.C.A.).

employer-paid trips is to be included in an employee's income.¹⁰¹ This position was upheld in what has now become one of the most frequently referred to Canadian cases on fringe benefits, *Giffen*.¹⁰² Similarly, where the employee's family uses the points, the fair market value of the benefit received by the employee's family is to be included in the employee's income. If the employer does not control the number of points accumulated under a plan (which is generally the case), the employee is responsible for keeping track of the points earned and used and reporting the fair market value of any tickets awarded on the points earned on employment-related trips.

Taxing employees on the value of the flights they take when they cash in employment-earned frequent flyer points is correct from both from an equity and an efficiency perspective. From an equity perspective, employees clearly value their frequent flyer points earned on business travel.¹⁰³ They plan when to use them on personal flights and delight in the free vacations they are able to take.¹⁰⁴ Frequent flyer miles, however, are not awarded to all employees, or even many employees. Also, not all employees who earn awards are able to use them. Some employers require their employees to use the frequent flyer points only for business flights. Moreover, the awards tend to be garnered by high-income employees who are required or able to fly as a result of their employment. None of the concerns about employees' being forced to consume certain in-kind benefits apply to frequent flyer points. Even though the employees may be required to fly as part of their employment, they are not required to

¹⁰¹ See IT-470R, *supra* note 57 at para. 14, which states:

Under this program, which is usually sponsored by an airline, a frequent air traveller can accumulate credits which may be exchanged for additional air travel or other benefits. Where an employee accumulates such credits while travelling on employer-paid business trips and uses them to obtain air travel or other benefits for the personal use of the employee or the employee's family, the fair market value of such air travel or other benefits must be included in the employee's income. Where an employer does not control the credits accumulated in a frequent flyer program by an employee while travelling on employer-paid business trips, [the employer will not be required to determine the value of the benefit and report that benefit on the T4 slip,] and it will be the responsibility of the employee to determine and include in income the fair market value of any benefits received or enjoyed.

¹⁰² *Giffen*, *supra* note 96.

¹⁰³ See *Adams v. Comark Inc.*, [1992] 5 W.W.R. 306, 42 C.C.E.L. 15 (Man. C.A.), where an employee refused to abide by an employer's change in policy, which would require all frequent flyer points be used on business flights. In that case, the court found that the value of the frequent flyer points earned by the employee on business-related travel was about ten per cent of the employee's salary.

¹⁰⁴ In fact, in one study conducted in the United Kingdom, the researcher found that the frequent flyer miles were generally overvalued by individuals. See Catherine Liston-Heyes, "Pie in the Sky? Real Versus Perceived Values of Air Miles" (2002) 25 J. Consumer Pol'y 1 at 20.

cash in or use their frequent flyer points for personal travel. The flights have a market value (the price of the flight), and so do the points themselves.¹⁰⁵

From an efficiency perspective, the case for taxing frequent flyer points is strong. In addition to the general economic inefficiencies created by the nontaxation of fringe benefits, a number of particular inefficiencies arise when frequent flyer points are not taxed. Presumably, the prices of tickets sold to business people are inflated to take into account the fact that many business people receive free flights from the accumulation of frequent flyer points.¹⁰⁶ In this way, the airlines are able to maximize profits by overpricing business flights (where businesses will bear the additional costs in part because employees receive the perk of frequent flyer points) while providing subsidized tickets to passengers who might otherwise not pay the full fare for travel.¹⁰⁷ In other words, businesses pay more than what might be the fair market value of the tickets because there is a bonus for employees who receive the frequent flyer points.

The system itself encourages employees to travel inefficiently. Employees are rewarded for taking longer flights, flying on more expensive tickets, or flying at peak times.¹⁰⁸ Gene Steuerle, a senior fellow at the Urban Institute, argues that airlines would be more efficient if they did not offer frequent flyer programs at all, but instead used more direct methods of implementing price discrimination. He states that “[t]he worst aspect of the competition is that it encourages employees to purchase more expensive travel as a means of increasing their own compensation. No firm would think of awarding bonuses to employees purchasing more expensive inputs for the firm. Yet this is exactly what frequent flier miles do. ... The non-taxability of the

¹⁰⁵ A recent article in *The Economist* reports,

The world has a new international currency: frequent flyer miles. Launched exactly 21 years ago, they are a lot like money. Collectors check their mileage statements as keenly as their bank statements. American courts often place a value on mileage balances in the course of divorce settlements. In a recent poll of frequent travellers, two-thirds said that they see frequent-flyer miles as the next best thing to actual cash ... (“Airline Miles: Frequent-Flyer Economics” *The Economist* (4 May 2002) 15 at 15).

¹⁰⁶ As argued by Richard Bird, “few would doubt that the cost of the giveaway has been factored into the price of the merchandise and services purchased to earn the bonus or reward” (Richard W. Bird, “The Legality of Frequent Buyer Plans” (2002) 81 *Can. Bar Rev.* 1 at 2).

¹⁰⁷ Jonathan Forman states that “[f]requent flyer programs are basically just complicated discounts for the purchase of multiple airline tickets.” This point also rebuts the argument that the frequent flyer points are provided to taxpayers as a “gift” for their repeated patronage—someone must be paying for that gift! (Jonathan Barry Forman, “Income Tax Consequences of Frequent Flyer Programs” (1985) 26 *Tax Notes* 742 at 742).

¹⁰⁸ One survey concluded that 25 per cent of frequent flyers admitted they took unnecessary trips. That study was reported in David W. Arnesen, C. Patrick Fleenor & Rex S. Toh, “The Ethical Dimensions of Airline Frequent Flier Programs” (1997) 40 *Bus. Horizons* 47 at 48. See also Keith McArthur & Gordon Pitts, “Fliers, Airlines Love Their Point Programs: Business People Take Unnecessary Trips, Carriers Make Money on Unsold Seats” *The Globe and Mail* (1 February 2003) B1.

additional compensation adds further to the incentive, but is not the principal component."¹⁰⁹ The general inefficiencies created by frequent flyer point systems have been the subject of considerable study.¹¹⁰

The only plausible argument supporting the nontaxation of flights taken with frequent flyer points earned on employer-related business is the difficulty of valuing them. But these administrative concerns do not outweigh the equity and neutrality considerations. Flights taken by employees using frequent flyer points are difficult to value because airlines offer such a wide range of prices for the same trip. Airlines develop a broad range of prices in order to price discriminate among customers with different elasticities of demand for their services (e.g., students, business persons, vacationers, and last-minute travellers). As a result of these various pricing techniques, the fair market value of a trip taken by an employee using frequent flyer points is admittedly not obvious.

In *Giffen*, the Tax Court of Canada offered a workable solution to the valuation problem. The court accepted a value that best reflected the amount the taxpayer would have paid to receive a ticket on the same flight, in the same class, and with the same kinds of restrictions as the free ticket the taxpayer received.¹¹¹ This holding is in line with the Revenue Agency's position, which simply provides that the employee has to report the fair market value of any benefit received. In *Giffen*, there was an additional administrative difficulty because one of the taxpayers used a first-class seat in his personal travel. First-class seats usually are not discounted. However, the court found an equitable way of valuing the seat by providing that the taxpayer was required to include in his income the value of the first-class seat multiplied by the proportion of the price of the most discounted seat in economy class to the price of a regular economy seat fare.

Commentators who favour the nontaxation of frequent flyer points have argued that *Giffen* will require an inordinate amount of work on the part of taxpayers to

¹⁰⁹ Gene Steuerle, "Frequent Flier Miles: Cheating Employers Is the Issue" (1995) 69 Tax Notes 1539 at 1539. See also Gene Steuerle, "Frequent Flyer Miles: The Issue Is More than Taxes" (1993) 60 Tax Notes 121.

¹¹⁰ Other arguments address some of the difficulties with frequent flyer plans more generally, including evidence that the plans significantly diminish competition because they create strong brand loyalty. See e.g. Arnesen *et al.*, *supra* note 108 at 48-49. There are also ethical and accounting concerns about the legality of frequent flyer plans. See e.g. Michael Y. Hu, Rex S. Toh & Stephen Strand, "Frequent-Flier Programs: Problems and Pitfalls" (1988) Bus. Horizons 52. Finally, for a discussion of the possibility that the plans violate criminal laws, see Bird, *supra* note 106.

¹¹¹ After the case was decided, the Revenue Agency issued a statement commenting on the method of valuation. The statement provides that "[t]he Department considers that the method of valuation adopted by the Court was *not unreasonable* and did not warrant an appeal" (Revenue Canada, Release 95-35, "Employee Benefits—Frequent Flyer Points" (17 November 1995) [emphasis in original]).

determine the value of their flights.¹¹² Tad Brown and David Wentzell suggest that to determine the value for tax purposes of a business ticket, the taxpayer would have to determine the cost of the full-fare business class ticket for that flight, the cost of a full-fare economy class ticket for that flight, and the cost of the most heavily discounted economy class fare on that flight.¹¹³ Airlines may not provide this information.¹¹⁴ Commentators have also argued that it will be impossible for taxpayers to keep the points they earn on personal and business flights separate.¹¹⁵

While administrative difficulties exist, if the approach in *Giffen* is seen to be too unwieldy, there are other alternatives to the valuation of frequent flyer points. For example, airlines or travel agents who disclose reward tickets to passengers based on their points under frequent flyer plans could be required to provide a fair market value of that free flight to the taxpayer for tax purposes. Another alternative would be to value frequent flyer points at their purchase price. In fact, anyone can purchase frequent flyer points over the Internet.¹¹⁶ The cost of purchasing the number of cashable points required to buy the flight identical to the one that an employee took on her points would be the value of the employee's benefit.¹¹⁷ To ensure that taxpayers are only taxed on their work-derived points, taxpayers could keep two frequent flyer plans—one to be used when business expenses are incurred and one when personal expenses are incurred. Finally, employers could implement policies permitting employees to redeem their points earned through work-related travel only on work-related travel.¹¹⁸

¹¹² See W.G. Tad Brown, "No Free Trip", Comment (1996) 44 Can. Tax J. 149; Bruce D. McCarley & Sheri J. Evans, "Recent Developments in the Taxation of Employment Income" in *British Columbia Tax Conference: Update on 1995-1996 Developments and Tax Planning Strategies* (Toronto: Canadian Tax Foundation, 1996). In contrast to the Canadian practitioners who have commented on this issue and who are generally in favour of nontaxation, at least some American practitioners have argued in favour of taxation. See e.g. Aidinoff, *supra* note 97.

¹¹³ Brown, *ibid.* at 152.

¹¹⁴ McCarley & Evans (*supra* note 112 at 11-29) similarly suggest that this approach to valuation is impractical, although creative.

¹¹⁵ See e.g. Veru Krishna, who argues that the requirement that employees keep track of their personal and business related points is "an entirely unreasonable expectation and most taxpayers will simply ignore Revenue Canada's call to turn Canada into a nation of bookkeepers" (Vern Krishna, "Around the Courts: Frequent Flyer Points" (1996) 6 Can. Curr. Tax 69 at 70).

¹¹⁶ *The Economist* reported the average price of a frequent flyer point to be somewhere between two and nine cents ("Airline Miles: Frequent-Flyer Economics", *supra* note 105).

¹¹⁷ The best price for consumers who purchase air miles from Air Canada over the Internet from the Aeroplan web page is three cents per mile. A return flight from Toronto to Vancouver requires "cashing in" 25,000 air miles. Therefore, the cost of a purchased air miles flight from Toronto to Vancouver is approximately \$750.

¹¹⁸ The federal government recently changed its policy to permit its employees to collect frequent flyer points for personal use. The government was quick to note that the employees would be required to pay tax on the value of the flights they subsequently take. In deciding to permit employees to

To date, the Revenue Agency has resisted pressure to revise its assessing position, and it should continue to resist these pressures.¹¹⁹ The inequities and inefficiencies created by the nontaxation of frequent flyer points are significant, and the administrative difficulties are not insurmountable. In fact, most of the inequity and inefficiency in this area is created because of the non-enforcement of the Revenue Agency's position.

F. Discounts on Goods and Services

It is often the policy of an employer to provide employees with the product or service sold by the employer at a discount. In some circumstances, the ability to purchase goods at a discounted price may even be a critical part of the employment contract. Discounted prices for merchandise or services purchased by employees can serve the needs of both the employer and the employee: the employer may benefit from the employees' using company products while the employee benefits from the lower price of the good or service.

Generally, employees are not required to pay tax on the discount they receive on goods or services from their employer. The only exceptions to this general rule are when a particular employee or select group of employees has an extraordinary arrangement with the employer or where an employee can purchase merchandise for less than the employer's cost.¹²⁰

collect frequent flyer points, the government noted the many additional perks that frequent flyers receive—expedited check-in, use of the airline lounges (which include free food and beverages), as well as free personal flights. Strangely, in this case, it was Walter Robinson, the federal director of the Canadian Taxpayers Federation, who worried “that the policy change could result in higher travel costs with taxpayers footing the bill.” The inefficiencies created by frequent flyer plans became a significant concern for Robinson in this context, even though the benefit would be taxed: Keith McArthur, “Bureaucrats to Receive Travel Perk” *The Globe and Mail* (1 June 2001) A4.

¹¹⁹ In fact, there has been very little discussion of the taxation of frequent flyer points in Canada since the release of *Giffen* (*supra* note 96) and the short flurry of activity afterwards. One might assume this is because the Revenue Agency does little to enforce the law in this area.

¹²⁰ IT-470R, *supra* note 57 at para. 27, which provides:

Where it is the practice of an employer to sell merchandise to employees at a discount, the benefits that an employee may derive from exercising such a privilege are not normally regarded as taxable benefits. However, this does not extend to an extraordinary arrangement with a particular employee or a select group of employees nor to an arrangement by which an employee is permitted to purchase merchandise (other than old or soiled merchandise) for less than the employer's cost. Furthermore, this treatment does not extend to a reciprocal arrangement between two or more employers whereby the employees of one can exercise such a privilege with another by whom the employees are not employed. A commission received by a sales employee on merchandise acquired for that employee's personal use is not taxable. Similarly, where a life insurance salesperson acquires a life insurance policy, a commission

For the purposes of the Revenue Agency's administrative policy, however, discounts generally are distinguished from discounts in the transportation industry. Airline passes available to airline employees are not taxable unless an employee travels on a space-confirmed basis and is paying less than fifty per cent of the economy fare. Where the employee travels under these conditions, she will be taxed on the difference between the amount paid and fifty per cent of the economy fare. Employees of bus or rail companies are not taxed on the use of passes, and retired employees of transportation companies are not taxed on pass benefits at all.¹²¹

received by that salesperson on that policy is not taxable provided the salesperson owns that policy and is obligated to make the required premium payments thereon.

The policy articulated in paragraph 27 is the same as that set out in paragraph 1 of 1964 Information Bulletin, *supra* note 64, which stated that

[t]he benefits that may be derived by an employee from exercising such a privilege are not regarded as taxable benefits. This does not extend to an extraordinary arrangement that may be made with a particular employee or select group of employees nor to an arrangement by which an employee is permitted to purchase merchandise (other than old or soiled merchandise) for less than the employer's cost.

The Revenue Agency has denied the extension of this policy to discounts on homes provided to the employees of residential construction companies: Revenue Canada, Memo 9318945, "Employee Discounts—Sale of Homes to Employees at a Discount" (26 November 1993). Similarly, discounts to employees of automobile insurance companies on automobile insurance have been held to be taxable as have waivers of banking fees: Revenue Canada, Memo 1991-103, "Employee Discounts—Automobile Insurance Premiums" (January 1991); Revenue Canada, Memo 9520365, "Employee Benefit from Free Banking Services" (12 September 1995). Promotional items and items sold at less than cost are also taxable: Revenue Canada, Memo 9607447, "Promotional Beer" (8 May 1996); Revenue Canada, Memo 9607284, "Taxable Benefits—Sale of Merchandise to Employees at Less than Employer's Cost" (30 May 1990).

¹²¹ IT-470R, *ibid.* at paras. 42-44. Those paragraphs state:

42. Airline passes available to airline employees will become taxable only if the employee travels on a space-confirmed basis and is paying less than 50 per cent of the economy fare available on that carrier for that trip on the day of travel. The value of the benefit will be the difference between 50 per cent of the economy fare and any amount reimbursed to the carrier for that trip.

43. Employees of bus and rail companies will not be taxed on the use of passes.

44. Retired employees of transportation companies will not be taxed on pass benefits under any circumstances.

Letters to specific taxpayers are consistent with the position taken in the Interpretation Bulletin. See *e.g.* Canada Customs and Revenue Agency, Memo 2002-0116934, "Airline Passes" (4 February 2002); Revenue Canada, Memo 9907048, "Taxable Benefit, Free Airfare" (27 May 1999).

The position set out in IT-470R (*ibid.*) is much more restrictive than the original exemption set out in 1964 Information Bulletin (*ibid.* at para. 2): "Where, in the transportation industry, an employee is given the privilege of a free pass for himself and his family on vehicles operated by his employer, he is not regarded as receiving a taxable benefit."

When employees purchase their employer's goods and services at a discount, they have received a personal benefit. The nontaxation of this benefit, therefore, results in inequities. Such benefits might be widely provided to employees in particular industries; however, the benefits are not required for employees to do their jobs and they are obviously not available to the great majority of employees who are not in industries that traditionally offer such benefits. In addition, the nontaxation of discounts on employer goods and services may lead to changes in compensation packages, and employees will be encouraged to purchase more of the discounted good or service than they would normally purchase. Finally, there are no significant administrative barriers to the taxation of employee discounts. Presumably, the employer knows the retail price of the good or service for sale and can keep track of the number of goods or services purchased by a particular employee at a discount. This is no more than what is required in their regular business practice.

The Revenue Agency should reconsider its position on employee discounts. Choosing to value discounts only where the discount is greater than the cost to the employer ignores the value of the benefit to the employee.¹²² Presumably, this position is justified on the basis either that employees are likely to value the goods and services of their employers less than the general population, or that employees are required to purchase these goods and services and therefore the value should be discounted because its receipt is involuntary. For many of the people who purchase their employer's goods or services, it is more reasonable to assume that the fair market value is the best approximation for these employees' valuation of the particular good or service. For example, it seems more reasonable to assume that a person who works for a computer company would like computers and would value them at their fair market value than it would be to make that assumption about the general population. Also, although it may be advantageous for employers to have employees using their goods or services, that aid to employers does not diminish the value of the good or service to employees.

The case against the nontaxation of discounts is most compelling in the airline industry, where the most generous policy applies. In that industry, presumably, employees accept lower salaries because of the benefit of low-cost (and in retirement, free) flights. One would imagine that the kind of people who are drawn to work in the airline industry are probably people who enjoy travel and who value travel benefits

¹²² Other commentators have proposed valuation approaches for discounts other than fair market value. For example, William Vickrey has suggested that an arbitrary percentage, 40 per cent or 60 per cent, of the fair market value could be used. Like the Revenue Agency, Vickrey fails to justify this suggestion, other than on purely administrative grounds. Vickrey assumes that the value of these in-kind benefits must be less than fair market value (but with no justification for that assumption) and from that conclusion suggests the arbitrary percentage of fair market value as appropriate (William Spencer Vickrey, *Agenda for Progressive Taxation* (New York: The Ronald Press Company, 1947) at 42).

highly.¹²³ Thus, the policy of the nontaxation of benefits from discounted or free flights effectively results in a government subsidy of salaries to employees of airlines. Who actually obtains the benefit of this subsidy—employers or employees—will depend on the relative bargaining strength of each group.

Generally, discounted goods or services purchased by employees should be taxed at their full fair market value in the hands of the employee.¹²⁴ If the good or service is not worth the full fair market value to the employee, then she should not be encouraged to purchase it. The fair market value of most goods and services should be easy to determine as generally they will be goods and services provided by the employer in the marketplace. Where there are restrictions on the discounted merchandise that the employee may purchase—for example, where an airline employee can only purchase tickets on a standby basis—then those additional restrictions should be reflected in the fair market value. Indeed, at present, the Revenue Agency's approach to valuation of airline employees' travel in vacant seats—where the Revenue Agency says there is no taxable benefit to the employee “in view of the difficulty in calculating the amount of employee benefit under the circumstances”¹²⁵—appears inconsistent with its position on the value of trips taken with frequent flyer points. It is hard to believe that the value cannot be calculated, and one suspects that this exemption is based entirely on political expediency.

Conclusion: Confounding Kleinwächter—Delimiting the Concept of Income

The potentially daunting task of taxing in-kind benefits was illustrated in the introduction to this paper by reference to Kleinwächter's conundrum: how to impose tax equitably as between an ordinary military officer, who experiences an austere military lifestyle while on the job, and a *Flügeladjutant* to the sovereign, who receives the same salary as the ordinary military officer, but who is able to enjoy many aspects of the sovereign's extravagant lifestyle while on the job. Simons despaired that the problem posed by Kleinwächter's conundrum was hopeless.

The *Flügeladjutant* receives lodging in the palace, dines at the royal table, has access to the royal horses for sport, is assisted by servants, and attends the theatre and opera with the sovereign. To make the tax solution to the problem even more disheartening, Kleinwächter asks us to assume that the *Flügeladjutant* detests opera and hunting. How can these differences in the personal consumption of the ordinary military officer and the *Flügeladjutant* be reflected in the taxable income of each? The

¹²³ This assumption is also made in “Federal Income Taxation”, *supra* note 27 at 1163, which similarly advocates for the taxation of retail discounts and free flights to airline employees.

¹²⁴ See also Sherbaniuk, *supra* note 83 at 67-68, and Ireland, Commission on Taxation, *First Report of the Commission on Taxation: Direct Taxation* (Dublin: The Stationery Office, 1982) at 192.

¹²⁵ Canada Customs and Revenue Agency, Memo 2002-0116934, *supra* note 121.

answer is, of course, that no tax system will ever accomplish this goal perfectly. However, it is possible to sensibly and fairly delimit the concept of income in the context of the taxation of in-kinds benefits by developing guidelines based upon the traditional tax policy criteria. In their application to specific types of in-kind benefits, these guidelines result in the development of a matrix of detailed rules that appropriately balance equity, neutrality, and administrability.

Can Kleinwächter's conundrum be resolved on the basis of the guidelines suggested in this paper? The quarters in the palace and the food at the royal table should be subject to tax. Each provides the *Flügeladjutant* with a clear personal benefit. These types of in-kind benefits are perfect examples of benefits that would have to be acquired in the absence of employment: everyone has to eat and be lodged. In addition, they are not provided widely to employees. If they were not taxed, compensation packages in many jobs could easily be adjusted to include analogous benefits. Admittedly, they do not have a readily determinable fair market value: meals that are required to be eaten with a sovereign and year-long lodging in a palace are not commonly bought and sold. Nevertheless, the forced consumption of these goods and services does not make them worthless. A reasonable value could be assigned to them by reference to similar meals and lodging.

The *Flügeladjutant* should also be taxed on his use of the royal horses for sport. This is the kind of service for which many individuals pay substantial amounts outside of an employment setting, and the use of the horses for sport would not appear to be required by the *Flügeladjutant's* employment. If he does not enjoy the use of the horses enough to be willing to pay tax on the value of the time he spends riding, he can always decline the benefit altogether.

Whether the *Flügeladjutant* should be taxed on the value of the servants he uses will depend on the use he makes of them. Do they simply assist him in discharging his responsibilities to the sovereign, or are they available to assist him with his personal responsibilities such as washing and pressing his ordinary street clothes, running errands, and assisting with personal grooming? In this latter case, the services of the servants should be a taxable benefit. These are personal activities for which every taxpayer should have to pay out of their after-tax income.

Whether the *Flügeladjutant* should be required to include the value of the tickets to the theatre and opera in his income will depend upon his responsibilities while attending these events. On the one hand, if he is required to protect the sovereign at these events, by being fully alert to possible threats and by keeping a watchful eye on the audience, his position is similar to that of a critic at the theatre or opera or a sports broadcaster at a sporting event. In this case, the value of the tickets should not be taxable. It might reasonably be assumed that the nature of the activities he is required to perform while attending the theatre and opera detracts substantially from his personal enjoyment. Moreover, the enjoyment he might derive is little different from the enjoyment that many employees experience from their work. On the other hand, if he merely attends as a companion, the value of the tickets should be included in his

income. It can be assumed that simply being required to attend with the sovereign does not sufficiently detract from the entertainment to justify nontaxation. His situation in this case is little different from that of an employee who has to accompany clients to sporting and entertainment events. The value of attending those events should be included in the income of the employee. The fact that the *Flügeladjutant* is required to attend these events as part of his employment is beside the point. If he derives a personal benefit from the events, the value of the benefit should be included in his income.

Finally, whether the *Flügeladjutant* has a personal preference for any of these perks is irrelevant to the question of taxation. His enjoyment (or not) is not the measure of his income; “the market value of rights exercised in consumption” is the measure of his income, and that measure operates without regard for his personal tastes. If the *Flügeladjutant* does not enjoy the personal benefits he receives from his employment, or at least if their value to him is not equal to the tax he has to pay on their fair market value, he should bargain for different remuneration. Ultimately, then, Kleinwächter’s conundrum presents reasonably solvable problems when the concept of income is appropriately delineated.

This paper has shown that a sensible set of guidelines, derived from the general principles underlying the income tax, can be used to formulate reasonable rules for the taxation of common in-kind benefits—such as the provision of educational courses leading to a university degree, combined employment-related and pleasure trips, clothing, subsidized parking, trips taken with frequent flyer points, and discounts on goods and services. The present tax law and administrative practice governing the taxation of in-kind benefits are often inequitable, in many cases lead to socially wasteful employee compensation, and frequently reflect a profound misunderstanding of basic tax principles. The courts and the Revenue Agency should use guidelines such as those formulated in this paper to develop a rational and consistent set of rules applicable to the full range of in-kind benefits that employers provide to employees.
