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Labour & Employment Law

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Employee Benefits: Taxable, or Not?

When it comes to payroll, employees usually trust their employer to correctly calculate and deduct source deductions, such as income tax and Employment Insurance (EI) and Canada Pension Plan (CPP) contributions, and to remit those deductions to the government on time. Sometimes employers make mistakes, such as neglecting to include the value of a taxable benefit when calculating source deductions.

The Canada Revenue Agency (CRA) expects employers to accurately report the value of taxable employment benefits for tax purposes. To do so, employers must first consider whether a fringe benefit is taxable, and, if so, determine its value and report it properly to taxing authorities. This is a significant requirement for an employer, as the misreporting of taxable benefits can affect not only its own liability for penalties and interest, but also its relationship with employees. An employer that fails to properly determine and report the value of taxable benefits may be faced with an employee relations nightmare if its employees receive unexpected tax bills as a result of the employer's error.

Misreported Taxable Benefits

The CRA performs Employer Compliance Audits of employer payroll records to ensure that employee remuneration, including taxable benefits, has been reported properly, and that related income tax, EI premiums and CPP contributions have also been accounted for and remitted. In the past, if CRA determined that remuneration had been understated by an employer, it might give the employer the option of adding the understated amount to its corporate income for tax purposes, i.e., allow the employer to reverse the expense deduction, and pay additional corporate income tax. However, CRA no longer offers this option to correct understated remuneration. CRA's view is that such arrangements do not protect employees' CPP and EI entitlements. CRA now requires that amended T4 information slips be issued to affected employees, which will trigger reassessments of their individual income tax returns for the years subject to audit by CRA.

Preventing the Problem

There are some things employers can do to avoid or reduce the ire of reassessed employees and the possibility of an assessment for penalties and interest on the unremitted tax. The first step is to perform a comprehensive review of all the benefits provided to employees, from formal employee benefit plans to one-off gifts or events, to determine whether any taxable benefits or allowances have been conferred but not reported, or underreported, for tax purposes.

The *Income Tax Act* (Canada) exempts some benefits from tax, such as private health insurance. Other benefits may not be considered taxable to the employee if they are provided primarily for the employer's benefit. This "primary beneficiary" principle was established by the Federal Court of Appeal in the 1996 case of *Lowe v. R*. In *Lowe*, the Court had to decide if an insurance executive received a taxable benefit when he and his wife were sent by his employer on an all-expense-paid trip to New Orleans with a group of top-selling brokers and their spouses. The Court found that the executive was required to attend the trip to ensure the brokers enjoyed themselves and that his wife was primarily engaged in hosting events for the employer throughout the trip. The Court held that the employer was the primary beneficiary of the trip. Therefore, no taxable benefit was conferred on the executive as a result of the employer paying his and his wife's travel expenses.

Many employers provide employees with small benefits from time to time, such as gifts and holiday parties. How does an employer know what benefits are taxable and how much to report in respect of non-cash benefits? The CRA publishes a number of guides and bulletins on its website which outline its policies on the benefits it considers taxable and how employers should determine the value of non-cash benefits for tax purposes (in some cases, including HST). CRA exempts certain benefits, such as non-cash gifts valued $500 or less per year or social events costing $100 or less per person, but considers others such as gift cards and mileage allowances beyond a certain prescribed rate to be taxable.

In some situations, the tax status of a benefit may not be clear. Employer-provided parking is one example. The CRA's general policy is that an employee receives a taxable benefit equal to the fair market value of the parking spot. An exception may apply if the employee regularly needs to use a car to perform employment duties as the parking would be considered to be provided for the employer's benefit.

Where a benefit enables employees to perform their job duties, employers should also ensure that they keep adequate documentation of the business purpose for providing the benefit, such as, for example, policies or memoranda setting out the employer's reasons for providing the benefit, the eligibility requirements and a method to determine personal use, such as mileage or usage logs.

Employer Responses to CRA Audits

Employers who are the subject of a CRA employer compliance audit may be assessed penalties and interest for amounts not withheld on unreported remuneration. In addition, provincial taxing authorities may also assess payroll taxes, such as Ontario Employer Health Tax, on the unreported amounts based on information received from the CRA under information exchange agreements.

Once employee reassessments are issued, employers should be aware of the reputational risks of doing nothing to maintain good relationships with employees. Employers may want to consider adopting a "make whole" philosophy by, for example, offering to pay the employees' tax liabilities plus an additional "gross-up" to reflect the fact that the employer's payment is itself a taxable benefit.

Reducing the Risk

To protect themselves and their employees from potential reassessments by CRA, employers can review the benefits they provide to their employees, seeking professional help where necessary, to ensure that they have correctly determined, valued, reported and documented all benefits and allowances paid to employees.

If your company's management dislikes unpleasant surprises, you may wish to consider undertaking a taxable benefits review in the near future.

The authors wish to thank Kerry Thomas of Ryan ULC for his assistance in developing this bulletin.

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Pallett Valo LLP Labour & Employment Practice

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