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POSITION PAPER ON THE ISSUE OF
THE TAXATION OF NORTHERN AND ISOLATED
POST BENEFITS AND ALLOWANCES

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A SUMMARY

The Issue

It is the intent of this position paper to address the taxation of northern benefits and allowances from the perspective of the Government of the Northwest Territories. It has been the practise of both public and private employers to provide their employees with various allowances or benefits which are intended to help offset the higher costs of living in the north. These benefits may take the form of housing subsidies, travel assistance or provision of benefits at a cost less than fair market. In most cases, these allowances are not being reported or taxed.

All these forms of benefits are taxable under the Income Tax Act. The issue to be resolved is whether or not the Federal and Territorial Government should give recognition to northerners by helping them offset the higher costs in underdeveloped or isolated areas of Canada, and if so, how. Stated another way, the taxing of an individual's earnings without reference to the comparative purchasing power of these earnings is inequitable. For an individual employee to enjoy a standard of living comparable to a southern counterpart (and so come or stay in the north) he must be compensated at a higher level. The employer must pass on these higher costs to the consumer thereby increasing the cost of northern goods and services even further. The employer as a result is less able to compete with southern businesses. The Federal Government has officially recognized the problem by issuing the 1980 Tax Moratorium and Remission Order.

Alternatives

- A) The subsidizing by Government of cost of living factors to lower the high cost of goods and services in the north to levels comparable to those in the south.
- B) Amendments to the taxation of earnings in the north by:
 - 1. Reducing the rate of tax in the north or provide a specific tax reduction.
 - 2. Provide additional personal exemptions in arriving at taxable income from net income in the calculation of income taxes for northerners.
 - 3. Providing a prescribed adjustment to income in calculating the net income of an individual in the north.

Discussion of Alternative A - Subsidizing Costs

Implementation

A direct cash subsidy would be paid to either the source of the higher cost or directly to the individual. For example a northern freight carrier would be paid the difference between his freight rates and southern freight rates in subsidies or each individual would be paid a cash subsidy to reduce his costs of goods and services (of which freight is but one) to southern levels.

Problems

Administration of such a scheme would be cumbersome, difficult, and much more costly than other alternatives. A continual monitoring of northern and southern cost differentials, changing subsidy levels, and a massive intervention through regulation into the private sector would be necessary. Elaborate controls to ensure the subsidy was passed on to consumers and that only those entitled to receive subsidies actually received them must be put in place.

Discussion of Alternative B - Amendments to Taxation of Earnings

General

By reducing the amount of taxes an individual must pay there would be more of his earned income left to pay the higher costs incurred when living in the north. Each individual would be treated equally under the Income Tax Act with the administration necessary for implementation already in place.

Problems

The initial determination of the size of the tax relief to be granted given differences in household sizes would be difficult. Also the fact that, even within the north there are differences between locations or regions, must be considered. A suggested solution to the varying costs of living within the north would be to define three (3) or more like-cost areas:

- a) Areas with access to the Mackenzie highway system.
- b) Areas without access to the same Highway system, but with access to mainline air service.
- c) Areas without access either to the highway system or mainline air service.

Implementation

Providing relief from the taxation of earnings can be accomplished in at least three (3) ways.

First, tax relief could take the form of a reduction in the rate of tax or as a final specific tax reduction. Both methods present problems in setting the amount of the reduction and how the reduction would be shared between levels of Government. Also a reduced tax rate would cause difficulties in calculating the relief of individuals who have moved between various tax areas.

Second, tax relief could be provided through additional personal exemptions which reduce net income in arriving at taxable income (the amount tax payable is calculated on). This method would eliminate the need for different tax rates between locations and the different tax reductions experienced in the first method.

Third, deduction of a specific amount directly from reported income tax to arrive at net income would provide tax relief. This method best achieves the taxing of individual income based upon relative purchasing power. Further it would be easily implemented and administered. Most importantly it would have the added effect of recognizing cost of living differences in the calculation of other Government programs such as Child Tax Credits and Old Age Supplement. The benefits to the individual are based on the Net Income figure which has been reduced by the northern living cost deduction.

Illustration of Alternative B Methods in Tax Calculation

Tax Calculation	Method		
	<u>1</u>	<u>2</u>	<u>3</u>
Total Income (including taxable benefits now not reported)	\$20,000	\$20,000	\$20,000
Less: Deductions from Total Income	0	0	Tax relief deduction = \$5,000
Net Income (figure used by Federal Government programs to determine level of benefit)	\$20,000	\$20,000	\$15,000
Less: Personal Exemptions	0	Tax relief deduction = \$5,000	0
Taxable Income	\$20,000	\$15,000	\$15,000
Tax Payable (Example)	\$ 2,000 Tax relief deduction = \$500	\$ 1,500 0	\$ 1,500 0
	\$ 1,500	\$ 1,500	\$ 1,500

Recommendation

Of all the alternatives examined, a deduction from total income to arrive at net income (Method 3) most fairly and simply provides relief from the higher cost of living experienced in the north.

GOVERNMENT OF THE NORTHWEST TERRITORIES

Position Paper on the Issue of
the Taxation of Northern and
Isolated Post Benefits and
Allowances

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Department of Finance
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Position Paper by the Government of the Northwest Territories on the taxation of Northern and isolated post allowances.

1. Introduction

In order to encourage northern development, it has been the policy of all governments and most private employers in the north to provide their employees with an "allowance or benefit" which is intended to help offset the generally higher costs of living in the north.

In the case of the Government of the Northwest Territories, these allowances take the form of housing subsidies, travel assistance and settlement allowances or through provision of benefits at a cost less than "fair market value".

Although the question of taxability of these "allowances" is specified in Section 6(1)(a) of the Income Tax Act, the strict adherence to these rules by this government and the majority of other northern employers, including the Federal Government, has not been followed.

In the case of most employers the allowances not being reported and taxed, have been primarily of the nature where payments were made to third parties, either directly or indirectly for the benefit of the employee, or charges to the employee for the use and benefit of certain employer owned facilities (primarily housing) at a nominal amount without the reference to cost or market value.

This situation has been questioned from time to time in the past, however, the practice continues,

1.1. Problem Definition

The question of whether or not northern benefits are taxable is not the issue at this point of time, as strict interpretation of Section 6(1)(a) of the Income Tax Act and interpretation bulletin IT71 confirms their taxability under current income tax legislation.

The real issue and problem to be resolved is whether or not the Federal Government and Territorial Government should give recognition to northerners by helping them offset cost in underdeveloped or isolated areas of Canada, and if so, how.

Current Situation:

With the issuing of the "April 3, 1980 Moratorium on the Taxation of Northern Allowances" and "Isolated Post Benefits and Allowances Remission Order of July 9, 1980" it would appear that the Federal government has officially recognized the problem, and has introduced a temporary corrective measure. This issue, however, requires an in-depth review and adjustment to:

- a) treat all people in similar circumstances equally.
- b) recognize that the purchasing power of earnings in certain situations must be taken into account in the imposition of taxes on those earnings and/or
- c) provide an incentive to persons living in areas defined in the Order, and/or
- d) at worst, retroactively condone contraventions of the law, by government and certain other sectors of the economy.

It is the belief of this government that the precedent for these adjustments already exists in Canadian Income Tax Legislation and Policy. Current legislation recognizes that the base on which to tax income must take into consideration different levels of well being owing to differences in factors such as age, health and environment, thus realizing that two persons with the same income may have different abilities to enjoy these incomes. This is achieved through the provision of deductions and exemptions to individual, income as prescribed by the Income Tax Act.

In the past few months, there have been a number of papers written and opinions expressed by other northern employers or interested third parties addressing the issue of the "taxation of northern benefits and allowances". It is the intent of this paper to address the issue from the perspective of the Government of the Northwest Territories as a spokesman for northerners and to make recommendations from that point of view.

In order to achieve this it is first necessary to review the issue which raises the concerns, and creates the problem. In addition, criteria for evaluating the alternatives are required.

III. Effect of Income Taxes on Costs in High Cost Areas

The taxing of individuals where earnings are set to reflect a higher cost of living tends to artificially further increase those costs. This is particularly true not only in the consumer market place, but in services rendered to government and larger industry. This can be illustrated by an example of a businessman operating in the above situation, whose business is highly labour oriented. In order to attract and keep employees in this isolated or high cost area, he is compelled to compensate his employees sufficiently to meet the variation in cost of living from one area to the other. Under existing law, this compensation is taxable and in order for the employee to have sufficient disposable income to pay for the additional cost he must, of course, be paid a sufficient additional amount to pay the taxes, to meet the additional increase.

Illustration:

Employer employs an individual to work in an area where the cost of living is some 25% higher than where the employee presently resides. The employer is naturally required to compensate the employee for this variation and the employee relates this to his current take home pay (disposable income). The result is as follows (assume a person taxed as single - 1979 rates):

	GROSS	AFTER TAX - NET
Present salary (annual)	\$19,000	\$14,800
Additional cost of living - 25%		3,700
Additional wages required to meet taxes and additional cost of living of \$3,700, at a marginal tax rate - 39%	<u>6,700</u> \$25,070	<u>18,500</u>
Percentage of present salary	132%	125%

The increase in wage cost by the employer expressed as a percentage of previous salary is 32% yet the variation in cost of living is only 25%. Therefore, the employer, to maintain an equivalent return, must pass on to purchasers of his goods and services a 32% increase and not a 25% increase in the labour factor of his costs. Governments must also reflect these increased differentials in their budgets to render services, and to date, particularly in areas of local government, such as municipalities and schools, must pass these on to property owners in the form of increased property and other taxes, further aggravating the higher cost of living.

It should also be noted that the above illustration does not provide any incentive to the employee but theoretically only maintains the purchasing power of his disposable income (after tax income) at the same level as his original situation.

Further effects on the economy in these particular areas of Canada as a result of these variations in cost manifest themselves in the difficulty of local businesses to compete economically with services and goods being provided from outside the high cost area. This has the effect of reducing the viability, given a fairly limited market area, of providing those services from within that market area, particularly where services are being rendered or there is a high labour content in the cost of goods being supplied.

IV. An Alternative Required?

Even without the issuance of the Isolated Posts Benefits and Allowances Remission Order, it has been obvious for many years that an alternative to the existing taxation of benefits was required. A continuation of obvious contravention of the laws of the land by all levels of government, as well as by large and small business without positive action by the agency legally charged with enforcing those laws, brings to question not only the equity of the law but the credibility of those laws. The law is being applied only to those least able to protect themselves and their employees from the agency charged with enforcing them. The self-employed, old-age pensioners, share holders and employees of smaller business bear the brunt of the tax assessor's application of the law. Also under the existing system, private home ownership, and independence from a "patronizing" employer are discouraged.

V. Some Alternatives

A number of alternatives have been discussed and proposed as solutions to the existing situation relating to the taxation of earnings in high cost areas in Canada. Some of these alternatives will be discussed later in this paper under their general headings. These will include:

- A. The subsidizing by government of cost of living factors to lower the high cost in certain areas to a level to compare favourably with the adjoining areas of Canada.
- B. Amendments to taxation of earnings in specified areas of Canada. This area will compare the following alternatives:
 - 1) Reducing the rate of tax or providing a specific tax reduction in prescribed areas of Canada.
 - 2) Providing additional personal exemptions in arriving at taxable income in prescribed areas of Canada.
 - 3) Providing a prescribed adjustment of income in calculating the net income of an individual residing in a prescribed area of Canada.

The continuation of the Remission Order is not considered for the purposes of this paper, as it is recognized as being an interim stop-gap measure and not a solution to the problem. The Remission Order does provide some relief to certain persons residing in prescribed areas, as well, to a limited extent, it does meet some of the evaluation criteria outlined below. However, it is lacking in too many of the evaluation criteria to be logically considered as a solution.

These options have all incorporated the requirement that all benefits be reported by employers in strict adherence to Section 6(1)(a) of the Income Tax Act which states:

"There shall be included in computing the income of a taxpayer for a taxation year as income from an office or employment such of the following amounts as are applicable:

VALUE OF BENEFITS

- (a) the value of board, lodging and other benefits of any kind whatever received or enjoyed by him in the year in respect of, or in the course of, or by virtue of an office of employment"

applied in accordance with the Department of the National Revenue's Interpretation Bulletin - 19-71R which discusses these benefits in detail.

VI. Evaluation Criteria

The above options will be evaluated and the related tax implications of each measured with the following objectives in mind:

A. Effect on Costs

That not recognizing the equivalent purchasing power of earnings by individuals artificially increases the cost of goods and services in the higher cost of living areas of Canada.

B. Purchasing Power

That the taxing of individual earnings must reflect the comparative purchasing power of those earnings, particularly in areas where the cost of living is substantially higher than the norm in the adjoining areas of Canada.

C. Equal Treatment

That all individuals living within specific areas contemplated in A and B above, obtain equal treatment and benefit from such recognition.

D. Legality

That the result of the change is to provide a method whereby the equalization of purchasing power of net discretionary disposable income does not require a continuation of the illegal practices which have evolved over the years.

E. Incentives

That the provision of incentives, in addition to equalizing the purchasing power of taxed earnings, is not a necessity, but a priority to be determined by governing bodies from time to time and should be considered separately from the matters being discussed in this paper.

F. Administration

That the alternatives are not overly cumbersome to administer.

G. Tax Revenues

That impact of the alternatives will not significantly reduce the tax revenues being generated from the taxation of these extra earnings by Federal and Provincial Governments.

VII. Alternate A - Subsidizing Costs

The reduction of high costs of living in specified areas by means of general government subsidies eliminates the requirements of criteria A, B, C, and D cited above. This option would not necessarily be contrary to criteria E, the provision of incentives, unless the effect of the subsidies was to reduce the cost of living substantially below that in the adjoining parts of Canada. However, the use of government subsidies would create an artificial economic environment and would tend to be misleading in assessing the viability of certain undertakings in the specified areas.

F. Administration

The administration of such a scheme would be cumbersome and extremely difficult to control, regardless of which level of the economy the subsidy was provided to. A subsidy provided at the source of cost e.g. freight carrier, would necessitate a monitoring of the subsidy through the carrier and on through the distributor/retailer to ensure the reduction in cost was passed on to the individual. A major intervention by way of regulation into the private and public sectors would be required to monitor the passing down to consumers of subsidies at the supplier level. An alternative would be to provide direct subsidies to individuals. However, this option would also require massive controls to ensure that parties receiving the subsidy were entitled or that all entitled were receiving the subsidy. Insofar as the latter are concerned, it is often the most deserving that fail to carry out the steps required to obtain the amounts that are due to them in this type of program.

G. Tax Revenues

The provision of subsidies to reduce costs is at least twice as costly to governments as opposed to the reduction of taxes imposed on income earned to meet those costs. The subsidy represents all of the additional cost; however, the tax reduction represents under current tax rates much less than 50% of those costs.

Certain offsetting returns to government could be experienced from the taxes on increased profits of suppliers in the area subsidized. These would, however, be minor in relation to the subsidy, particularly because:

1. A large portion of the cost of living is rendered by non-taxable entities such as, Northern Canada Power Commission, Northwestel, Northern Transportation Company Ltd., Municipal Governments and similar bodies.
2. A close monitoring of the subsidies would attempt to ensure that profits earned were not a result of the subsidies which should have been passed on to consumers.

VIII. Alternative B - Amendments to Taxation of Earnings

The three options presented for comparison are similar in many aspects and will be compared as to their own unique advantages and disadvantages following a general discussion under the criteria previously set out.

A. Effect on Costs

Any reduction in taxes on earnings required to meet higher costs in specific areas of Canada would lessen the impact taxes have on costs in that location. This meets favourably with the general criteria set out above.

B. Purchasing Power

A reduction of taxes which may be provided because of higher cost would be recognition of a variance in purchasing power of earnings. Care would have to be taken to ensure that any reduction does not over-correct the imbalance with the result that an incentive is then provided.

C. Equal Treatment

The Income Tax Act, as constituted, applies equally to all individuals in Canada. Equal treatment, except for variations in the three options presented, would be achieved given that the laws were enforced uniformly.

D. Legality

As stated in C above, an amendment to taxation of the earnings in

(currency practice) ...
responsible ...
law would have to be dealt with in strict accordance to the provisions of the Income Tax Act.

E. Incentives

A program on which exemptions from or reduction of tax aimed solely at recognizing the variance from cost of living in adjoining parts of Canada would not necessarily result in incentives being provided. Variations in level of costs in specified areas would, of necessity, be required. *eg.* Costs of living in certain specified areas may be some 20% higher than the adjoining part of Canada, whilst in another they may be as much as 30% higher.

F. Administration

As indicated earlier, achievement of the proper result from these alternatives would require the strict adherence and uniform enforcement of the Income Tax Act and regulations which require the reporting of benefits received by virtue of office of employment. The administration is already in place to ensure this application of the law. However, other problems do present themselves in the application of these options, namely:

1. Determination of the Benefit Received

Interpretation Bulletin IT-71R generally sets out the basis accepted by Revenue Canada for the determination of the quantum of a benefit and what constitutes a benefit. The bulletin refers to "reasonable estimates" and other phrases such as an amount "the employee would have to pay someone else" for accommodation. The determination of the rental value of accommodation provided by an employer could become contentious even where comparisons would be available. The rental value of accommodation in extremely remote areas or in centres where virtually all accommodation is owned or under control of the employer does not provide for reasonable comparison (there is no "someone else"). More specific guidelines would be necessary to determine the quantum of the benefit.

Employee choice of housing is very often the prerogative of the employer, and in many instances, particularly if the choice affects his taxes, an employee may wish to be provided with lesser accommodation resulting in less benefit. The employer may not have this available or may insist on the type of accommodation to be occupied by certain levels of employees. The lack of other possibilities to the employee in these situations brings to question "what he would have to pay someone else" as a measurement of "benefit".

2. Amount of Relief

The determination of the amount of the variance in cost of living from the norm in adjoining parts of Canada would be a difficult task as well as prescribing the areas to which a tax relief would apply. The calculation would involve extensive review and study of prices, costs, and amenities available or not available in various regions or centres. eg. There may be no roads and the cost of maintaining a vehicle is not then part of the cost of living. Would this situation then reflect as a reduction of overall cost in a high cost area?

The parameters of determining the amount of relief and the regions would have to be very carefully laid out if a fair result is to be achieved.

The variation in the cost of living within certain areas of Canada is similar for many areas, and whilst, perhaps not being exact in all centres, could within reasonable limits be comparable. eg. In the Northwest Territories perhaps two or three areas could be prescribed.

- a) Areas with access to the Mackenzie Highway system.
- b) Areas without access to the same highway system, but with access to scheduled air service.
- c) Areas without access either to the highway system or scheduled air service.

Another factor which could affect the amount of the deduction would be the recognition of the family or household unit. The adage "two can live as cheaply as one" does partially operate in comparing relative costs of living. The suggested alternative would be to offer a specific reduction to the first member of a household or family unit with additional lower allowances for each additional member or dependent. The determination of the amount could bear the same relationship as the personal exemption for self, spouse, and dependent children under 16 and over 16 years of age.

Whilst the arguments presented above suggest an "exactness" of relief this would not be necessary. The objectives would be achieved if the relief were reasonably close to the variance in question.

The high mobility of the Canadian work force would result in persons working through the year in both prescribed regions and non-prescribed regions of Canada. The present method of determining taxation rules on the basis of residency at December 31 would, of necessity, require modification in relation to the claiming of relief to ensure the individuals leaving a prescribed region received the relief for the time employed in the area and individuals moving into the region receive relief only for the time employed in the area.

G. Tax Revenues

This alternative requires the reporting of all benefits to employees by employers in the prescribed manner. As a result of this necessity, individuals would be required to account for taxes on millions of dollars of benefits previously unreported. Whilst this alternative envisions tax relief from taxation of certain of these benefits, the suggested relief is only intended to extend to the variance in the cost of living. A large proportion of the individuals receive unreported benefits far exceeding the variation in cost of living. The extending of exemption from taxation of benefits (or alternatives) to those individuals to whom it does not presently apply (under the Remission Order) will be more than offset by the taxing of benefits received in excess of the variation in costs. eg. It is highly probable that the leasing of a \$125,000 home to an employee for amounts ranging from \$-0- to \$150 per month is an excessive adjustment in equalizing the cost of living, and no doubt contains a major incentive.

IX Options to Alternative B

The advantages and disadvantages aside from those discussed above of the various options within the alternative to change existing taxation are set out below, under the criteria wherein they differ.

A. Option B(1) - Reduction of Tax Rate or Tax Reduction

The application of a deduction in tax rates or providing a specific tax reduction, whilst offsetting the effects of taxes, would present certain difficulties in setting the amount of the reduction and how it is to be shared by differing levels of government. Given the progressive rates of tax in the Canadian tax system, persons in higher income levels would pay more tax on the additional income needed to meet higher costs than persons in lower income levels.

This scheme would be further complicated by the movement of persons from area to area during a calendar year, and how to vary a reduction in rates to that situation. This option would result in a very complicated method of varying of rates or reductions to recognize levels of income, location and time in the location.

The tax reduction would not offset the effects of higher incomes to meet higher costs insofar as other aspects of the Income Tax Act such as the Child Tax Credit or other government programs requiring a means test based on the net income reported on an individual's personal tax return. These programs include the Old Age Supplement, low rental housing and other provincial social assistance schemes.

Illustration:

Assume that it requires an additional \$6,000 per annum of net disposable income in a specified area to support a family with two children as opposed to the adjoining parts of Canada. At a marginal tax rate of 39% it would require some \$9,800 in income before tax to provide that disposable income. This has the following effect on the child tax credit means test:

a) Employee resides in non-specified area and his income is	\$18,000
b) Employee resides in area specified above, in order to maintain an equivalent standard of living, he must earn	\$27,000
1979 Child Tax Credit in a)	\$ 436
1979 Child Tax Credit in b)	\$ 27

These variations have an even more dramatic effect when applied to the old age supplement. This premise may be countered by the argument that government services in these specified areas cost more and should be paid from those additional tax revenues. The question remains, should this be borne by the individual in that area or equalized across the nation and shared by all taxpayers receiving specified services of the same kind?

B. Option B(2) -- Additional Personal Exemptions

This option suggested additional personal exemptions be deducted from net income in arriving at taxable income. This approach eliminates the difficulties outlined in Option 1 related to the progressive rates in that the deduction would be universal (within limits) and could be easily prorated by day for changes in location. The means test inequalities would not be met as the deduction is after determination of the net income of the individual.

C. Option B(3) -- Deduction from Income

The deduction of a specified amount from income in prescribed areas of Canada to arrive at net income would achieve most exactly the relationship of taxing individual income based on its relative purchasing power. It would apply equally, providing benefit to all for tax purposes and in other areas involving social assistance programs.

The administration of such a plan would require amendment only to the Income Tax Act and except for determination of the prescribed areas and prescribed reductions of income, would parallel the administration of other existing deductions such as the education deduction.

X. Conclusions

The effect of taxes on the income required to meet higher costs has been illustrated to result in somewhat inequitable treatment of higher earnings by individuals living in high cost areas as opposed to individuals living elsewhere in Canada. Higher cost of government services in these areas could justify the additional taxes; however, if this were the objective of the government, it could also follow that governments choose to discourage the evolutionary development of the areas in question by further increasing cost through taxes. As the latter statement is neither a stated nor an implied objective of present governments, this argument has not been explored at length. The assumption has been made that the cost of government services throughout Canada should be shared equally by all citizens within their capacity to pay. The taxing of individual earnings without reference to the comparative purchasing power of those earnings in the instances noted above, causes the opposite effect.

Regardless of the final determination of the treatment of benefits in the areas specified in the "Isolated Posts Benefits and Allowances Remission Order", it is time that the laws be enforced and enforced equally in these matters, or changed to reflect the needs of the situation.

Of the alternatives explored above, the one which appears to meet the criteria, as well as recognize the need for adjustment for all persons involved is the option to allow a deduction in arriving at net income.

The introduction of any of the above alternatives, none of which are perfect solutions, will not correct all the faults or meet all the objectives of any proposed change, but would eliminate many of the inequities in the existing laws as they exist or are being applied today.

