

## VI. IMPACT OF INDIVIDUAL TAXATION

Ideally, the value of all pay and benefits which are tax free or which carry de facto tax benefits should be grossed up to ensure that the values of benefits and pay are assessed consistently having regard to tax liability. The impact of taxation can be significant. This is not only because many fringe benefits attract no tax, but more importantly because the mix of cash and non-cash compensation can vary widely. It is really the mix that is the crucial item. If the mix of taxable and non-taxable compensation were the same for each organization, there would be no need to reflect tax rates for purposes of comparing total compensation. However, differing mixes will result in different values of total compensation if an adjustment is made for tax.

The purpose of this Section is to outline a procedure for incorporating the impact of taxation into the total compensation analysis. This will be done by extending the simplified illustrations used elsewhere in this report. We will then deal with other issues.

The two basic questions to address are "where" and "how" to incorporate taxation into the process. We shall deal with each of these in turn.

### A. WHERE TO INCORPORATE TAXATION

Referring back to Table III-1, it will be apparent that there are two places where the effect of taxation could be reflected. These are:

- in the centre of the Table where the individual benefits are valued using the Standard Population

-- near the bottom of the Table where the total compensation comparisons are made between the public and private sectors.

The first alternative is impractical. The second alternative is much more feasible. At this point in the process, a direct comparison of pay and benefits is being made for comparable positions in the public and private sectors. It should be possible, therefore, to gauge the impact of taxation on this comparison.

#### B. HOW TO INCORPORATE TAXATION

In Section III, a process for establishing total compensation equality was illustrated. For illustrative purposes, we made an assumption of identical working hours in the two sectors. After following the procedure outlined in Section III, we saw that total compensation equality was achieved when the components of total pay were as follows:

	<u>Public Sector</u>	<u>Private Sector</u>
Annual base salary	\$138,292	\$132,000
Fixed bonus	<u>0</u>	<u>11,000</u>
Total cash compensation	138,292	143,000
Value of retirement benefits	20,744	15,985
Value of medical benefits	<u>500</u>	<u>551</u>
Total benefit value	21,244	16,536
Total compensation	\$159,536	\$159,536

From a Salaries Tax point of view, this comparison can be simplified into the following:

	<u>Public Sector</u>	<u>Private Sector</u>
Taxable compensation	\$138,292	\$143,000
Non-taxable compensation	<u>21,244</u>	<u>16,536</u>
Total compensation	\$159,536	\$159,536

If the non-taxable compensation is grossed up for tax, the tax-adjusted compensation is as follows:

	<u>Public Sector</u>	<u>Private Sector</u>
Taxable compensation	\$138,292	\$143,000
Non-taxable compensation	21,244	16,536
Tax adjustment	<u>7,081</u>	<u>5,512</u>
Total compensation	\$166,617	\$165,048

Because the mix of taxable and non-taxable compensation is different in the two sectors, the tax-adjusted total compensation is different. In this example, the tax-adjusted total compensation in the public sector is \$1,569 higher than in the private sector.

In order to re-establish total compensation equality, it is necessary to reduce public sector cash compensation. In this example, the marginal tax rate is 25% and the adjustment can be made as follows:

$$\begin{aligned}
 \text{TAX ADJUSTED} \\
 \text{CASH COMPEN-} &= 138,292 - 1,569 \div \left[ 1 + \frac{\text{Pay-Related Benefit \%}}{1 - \text{Marginal Tax Rate}} \right] \\
 \text{SATION} &= 138,292 - 1,569 \div \left[ 1 + \frac{0.15}{0.75} \right] \\
 &= 138,292 - 1,569 \div 1.2 \\
 &= 138,292 - 1,308 \\
 &= 136,984
 \end{aligned}$$

The tax-adjusted total compensation comparison then becomes:

	<u>Public Sector</u>	<u>Private Sector</u>
Taxable compensation	\$136,984	\$143,000
Non-taxable compensation	21,048	16,536
Tax adjustment	<u>7,016</u>	<u>5,512</u>
Total compensation	\$165,048	\$165,048

C. COMMENTS ON TAX ADJUSTMENT

1. The tax calculations have been based on a family with two children and a sole breadwinner. Tax tables applicable for the 1985/86 tax year have been used.

Obviously, this is an assumption. Individual tax positions will vary. Nonetheless, it is important to assess how material the impact of taxation can be on the total compensation comparison. By consistently applying this assumption, the comparison is fair and in fact will produce more reasonable results than would be produced by ignoring tax.

We recommend, therefore, that total compensation measurements include the effect of taxation.

2. In the illustration, the calculation is quite straightforward since a marginal tax rate of 25% is applicable throughout. At certain salary levels, the calculations become slightly more complex because changes in compensation levels may mean differing marginal tax rates at differing compensation levels. However, the principles remain the same; the calculation merely becomes more complicated.

3. A further adjustment is required for retirement benefits payable in the form of a pension since these payments are subject to salaries tax. The adjustment is quite straightforward and can be made as follows:

(a) determine the annual pension ultimately payable and express it as a percentage of final earnings

(b) apply this percentage to current earnings to determine how much the pension would be in today's dollars and calculate the tax that would currently be payable on a pension of that amount

(c) calculate the effective tax rate by dividing the tax payable in (b) by the pension in (b)

(d) reduce the value of the retirement benefit by the tax rate determined in (c)

This reduced benefit value is then grossed up for tax as described earlier. This has not been included for the public sector employee in the illustration in order to keep it simple.

4. Housing benefits present a special issue in the private sector. Since the value of private sector benefits is arrived at by aggregation, therefore the value of housing will reflect the fact that some companies provide housing benefits and some do not. It is conceivable, therefore, that at some salary levels the value of the housing benefit will be less than the imputed rental value of 10% of assessable income. As a practical matter, in these cases the value of housing should be taken as the lesser amount.

## VII. DATA COLLECTION

There are two aspects to data collection for fringe benefit valuation. The first aspect is the process and the second is the specific method by which data is tabulated and summarized.

### A. DATA COLLECTION PROCESS

The process is important to ensure that complete and accurate data is obtained. The process is most time-consuming in the first year that data is collected. Thereafter, it becomes less onerous since procedures and a validated data base have been established. Our recommended approach to the process is as follows:

1. Prepare and distribute a data collection package. The package would contain a set of instructions and standard data collection forms (see B below). The data collection forms would be pre-completed to the extent possible using existing data. This will make it easier for private sector employers to review and complete the forms.
2. The completed forms should be returned. Copies of formal plan rules, insurance contracts and employee booklets should all be returned.
3. The completed forms should then be reviewed for completeness and accuracy. The more complex benefits (e.g. retirement) should be reviewed by a person knowledgeable in this area to ensure that the plan provisions are accurately extracted.
4. Where there is any question as to the accuracy of the completion of the forms, or where supporting documentation cannot be provided, a validation meeting should be held with the employer.

## B. DATA TABULATION AND SUMMARY

Under the Standard Population Method, two types of data are required. These are the benefit plan provisions and employee headcounts (numbers in each company and the number of employees eligible to participate in each benefit plan).

1. Tables VII-1 and VII-2 show specimen data collection forms.
2. Standardized plan summaries, such as shown in the specimens, are essential in the first year of the valuation. However, it will be necessary to abstract data from these summaries and enter it onto a data coding form for computer entry.
3. Ultimately, it would be desirable to eliminate the data collection forms and instead have data changes entered directly onto the data coding forms. This will save resources by eliminating the abstraction step. However, there are good reasons for not proceeding directly to this step in the first year. These reasons include:
  - (a) The data coding forms should be stand-alone documents and, as such, must capture all the plan features (and only those features) pertinent to the valuation of benefits. The quality of the form will be higher by including the intermediate step in the first year.
  - (b) A well-designed data coding form could, to an extent, be completed by the employer. However in the first year, the plan summaries will be more meaningful to many employers. The data coding form could then be designed to be parallel to the data collection form to make it more understandable to employers.

TABLE VII-1  
SPECIMEN DATA COLLECTION FORM

LOCAL STAFF

NO. ELIG. TO PART.	RETIREMENT BENEFITS								
	Eligibility	Plan Salary	Normal Retire- ment Age (NRA)	Contributions		Normal Retirement (NRB)	Permanent Disablement	Death	Resignation
				Employee	Employer				

NO. ELIG. TO PART.	INSURANCE PLANS (In addition to provisions under the Retirement Plan)														
	Eligibility	Group Life				Benefit Amount	Eligibility	Permanent Disablement			Benefit Amount				
		Contributions		Payment Upon	Employee			Employer	Employee	Employer		Benefit Amount			
		Employee	Employer												