Taxation of Customer Loyalty Programs

By: Akhil Agrawal & Chun Kiu (Jacky) Lai

INTRODUCTION

The taxation of customer loyalty programs has been a hot topic in Canada and the United States for the past 30 years. The issue of frequent flyer miles has been an elusive problem for the Canada Revenue Agency (CRA), which is known for trying to tax everything within its powers. In fact, Canadians spent over $22 billion on corporate travel in 2012 alone[1], yielding millions of rewards points as a result. In the U.S., the total value of loyalty points is estimated to exceed $48 billion, and the average household being a member to 18 different programs[2]. It is easy to see that the nations worldwide are leaving millions of dollars on the table each year by being passive in this regard. The purpose of this paper is to examine the current law and make recommendations for improving the taxation of customer loyalty programs. A focus will be placed on frequent flyer type programs as it is one of the few customer loyalty programs where the potential tax revenues can exceed the costs of implementation. From a theoretical perspective however, the ideas presented here are applicable to any customer loyalty program.

First, an assessment of the current legislation in Canada and various nations worldwide will be performed by comparing it to the tax policy goals as stipulated by the American Institute of Certified Public Accountants (AICPA). Next, advantages and disadvantages of different alternatives available will be examined in an attempt to improve the current system. Based on the

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[1] GBTA Study Finds Business Travel Spending to Grow Globally (GBTA Study Finds Business Travel Spending to Grow Globally) *Global Business Travel Association*. Web. 3 June 2014. <http://www.gbta.org/foundation/pressreleases/pages/rls080513.aspx>.

[2] "Frequent Flyer Miles, Thirty Years Later."*FrequentFliercom*. FrequentFlyer.com, 13 Mar. 2011. Web. 3 June 2014. <http://www.frequentflier.com/news-analysis/features/frequent-flyer-miles-thirty-years-later-2/>.

information gathered, the paper will provide a recommendation on how to address the issue in Canada.

OVERVIEW OF CUSTOMER LOYALTY PROGRAMS

Due to their effectiveness, customer loyalty programs have been adopted by many large corporations around the world. Many of them offer an impressive variety of rewards which are typically redeemed using points generated through purchases. The simplicity behind the frequent flyer program has caused it to become the most successful marketing program in the airline industry[3].While the individual details may vary slightly, the overall structure remains the same, using either a points based system or a discount based system. The following will discuss some of the common customer loyalty programs found in Canada and internationally.

AIR MILES

The Air Miles rewards program is arguably one of the largest programs in the world that offers a wide range of rewards to members based on “miles” generated through purchases from its many partners. The program was created in 1992 and has enjoyed immense success resulting in over 10 million active Collector accounts in Canada[4]. The Air Miles program is offered in several countries across the world including the U.S., Spain, UAE, and the Netherlands.

Earning Miles

The process of earning “miles” is the driving force behind the program and is the digital currency that is used to redeem rewards through the Air Miles system. There are three main ways to earn miles: in store, online, and everyday purchases through the use of an Air Miles payment product.

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[3] Morales v. Trans World Airlines, Inc., 504 U.S. 374, 407 (1992)

[4] "AIR MILES Reward Program."*Industry Canada*, 8 Feb. 2013. Web. 8 July 2014. <http://www.ic.gc.ca/app/ccc/srch/nvgt.do?lang=eng&prtl=1&estblmntNo=234567044661&profile=cmpltPrfl&profileId=501&app=sold>.

In Store

The most basic way to earn miles is through in store purchases. Whenever a member spends money at one of the sponsor’s locations, the member will earn miles based on a predetermined formula. This formula is unique to the sponsor itself and varies quite widely between different sponsors. As a result, a dollar spent at one sponsor will yield a different number of miles than a dollar spent at a different sponsor’s locations. Air Miles has over 120 sponsors offering a wide variety of goods and services, ranging from groceries and clothing to hotels and car rentals.

Online

Air Miles members can also collect miles when they shop online at one of their online sponsor’s webpages or through the Air Miles web portal at airmilesshops.ca. The program currently offers a selection of over 100 different online sponsors to choose from, and each has their own reward rates as well. Unlike the in-store sponsors, the rates for the online sponsors are fairly consistent at 1 mile per $20 spent.

Air Miles Payment Products

Air Miles has partnered with many major credit card companies that allows customers to automatically earn Air Miles when they spend at one of the sponsor’s stores. This offers the greatest amount of convenience since the system will automatically check if the vendor is an Air Miles sponsor and then calculate the appropriate rewards earned from the purchase. These payment products can be used for in-store and online purchases, many times at a higher rate than the in-store and online reward rates. Furthermore, these payment products also allow members to earn miles for purchases from non-sponsors at a fixed rate per class of item purchased.

Redeeming Miles

In order to obtain the rewards from the loyalty program, members must redeem their miles into *Air Miles Cash* or *Dream Rewards*. Under the Cash program, members can redeem 95 miles for a $10 gift card that is valid at 13 different participating stores including Shell, Starbucks, Rona, and more. The number of participating locations varies from province to province, with Quebec having the highest at 17. Under the Rewards program, however, members are given a much larger variety of rewards allowing them to redeem miles for electronics, event tickets, flights, vacation packages, and much more. These rewards are provided directly by Air Miles and each item requires a different number of miles to redeem. We have selected a sample of random non-flight rewards in Appendix A. In order to determine the retail price for each reward, we looked at several well established retailers such as Amazon, BestBuy, and the individual manufacturer's website and used the lowest or most common retail price found if the lowest price was unusually low due to a store promotion. Since each reward has a significantly different fair value, we would expect the number of miles required to redeem each reward to vary in proportion to its retail cost. After dividing the total miles by the retail value of the prize however, we found that this was not the case, and some products had a significantly higher ratio than others.

If given more time, the next step for us would be to perform a similar exercise for the flight rewards that are available as well. To do this we would use the Air Miles system to find the cost in miles for several short-haul and long-haul flights that are domestic (within Canada and the U.S.) and international (at least one flight to each of the following continents: Europe, Asia, South America, Africa) using random date ranges. We would then consult popular travel agencies such as Expedia.com and Kayak.com in order to obtain a price (in CAD) for the same flight and date range. We would track the cost of the price over a 10 day window and take the average price in our calculation in order to adjust for volatility in flight prices. We would then divide the cost in miles over the cost in CAD in order to determine a value per mile such that it can be compared with the non-flight rewards. We expect flight rewards to be valued much lower than the non-flight rewards on a per mile basis because programs like Air Miles and other rewards programs typically aim to offer a 1-2% return for members. Considering that non-flight rewards seem to offer as much as 10 cents per mile as illustrated in Appendix A, it is reasonable to expect that flight rewards should balance this out.

Air Miles members also receive other benefits from the program at no extra cost. These benefits usually take the form of purchase discounts at other participating retailers that are available to all members regardless of their points balance.

Tax Implications

From a tax perspective, the variety in which points can be earned and redeemed makes it very difficult to value the miles in order to calculate the tax liability earned on employer generated miles. For example, an employee who earns miles from flight expenditures obtain these miles at different rates depending on which payment product they are using. Next, when the employee goes to redeem the miles, they have to choose between the cash option or reward option. Under the cash option, the valuation would be simple since each $10 voucher is redeemable for 95 miles indicating that each mile should be valued at $0.1052. However, if the member chooses a reward option, valuation becomes much more difficult considering that the fair value of each reward is different. If the member redeems miles for flight or vacation rewards, it can become more complicated since miles can be used to pay for portions of the vacation package or flight, and cash to pay down the remaining amount. Furthermore, regular prices for flights and vacation packages fluctuate significantly on a daily basis, and vary widely between different travel agencies. This means that a successful tracking system would not only have to keep track of the value of the flight on the day the points are redeemed, but also have some mechanism to incorporate the different prices for flights to arrive at a fair value for the reward.

PETRO-POINTS

Petro-Points is yet another type of customer loyalty program that is offered by Petro-Canada to customers who purchase gas, car washes, and other products from their gas stations. In principle, it works the same way as the Air Miles program where points are earned from cash expenditures and can subsequently be redeemed for rewards. The Petro-Points program is much simpler however since members can only earn points on purchases from Petro-Canada or one of six different partners. Appendix B outlines which Petro-Canada purchases qualify for rewards and the rate at which they are distributed. Points can be redeemed for various Petro-Canada products such as gasoline, car washes, and vouchers with four of their partners. In addition to this, points can also be donated to a few Canadian charities or converted to a different customer rewards program, Asia Miles, where it can be used to redeem other rewards.

In Appendix B, we have selected a sample of some of the most common rewards selected in the Petro Points system. It is important to note that the number of rewards available is significantly lower than in the Air Miles program, and as a result, our sample is also much smaller. Virtually all of the rewards pertain to consumer products sold at the gas stations which are usually nominal in value (approximately $15 or less). For some of the products, we were unable to find the retail price of the product online and therefore used the price of an equivalent non-Petro-Canada brand product instead. We found that the value of the Petro-Points were significantly lower than miles under the Air Miles reward program, with most products yielding a valuation of less than $0.001 per Petro-Point.

Tax Implications

Rewards earned from employer-reimbursed expenditures at Petro-Canada gas stations also represent a taxable benefit the same way rewards from Air Miles programs do. There are many examples of companies who provide employees and directors with car allowances that help reimburse the cost of operating the vehicle, including expenditures on gas, allowing employees who are members of customer rewards programs such as Petro-Points to earn credits without incurring any personal expenditure.

Due to the limited number of ways that Petro-Points can be redeemed, valuation is much easier than in the case of Air Miles. Points are typically redeemable in the range of 1,000-2,000 points per dollar yielding a value of $0.001-$0.002 per point (Appendix B). Furthermore the items that the points can be redeemed for are much more stable in value which simplifies the valuation process.

TAX THEORY OF CUSTOMER LOYALTY PROGRAMS

Frequent flyer miles that are accumulated through personal travel are generally viewed as "rebate for part of the cost" of choosing to provide a certain amount of business to a particular airline and are really a "purchase price adjustment" rather than income that is taxable[5]. This appears to be reasonable since such volume rebates are commonplace in the retail industry. For example, a customer who takes advantage of a "Buy one get one half off" promotion does not treat the extra discount as income, but rather, a reduction in the true cost of the items purchased. Under this bargain purchase theory, the same logic should apply to airline tickets. Free tickets

[5] Kathy Krawczyk & Lorraine Wright, How Should Frequent Flyer Miles be Taxed?, 79 TAX NOTES 1029 (1998)

obtained from the use of personal frequent flyer points is really a reduction in the true cost of the earlier tickets purchased to generate those points[6].

Frequent flyer points earned through business travel is a different story however. Most tax academics believe that these points do not represent a tax-free bargain purchase, but rather a taxable benefit for the employee[7]. This is supported under tax benefit theory which states that events in the current year that are fundamentally inconsistent with the tax treatment of those situations in a prior year must be 'disgorged' by the taxpayer by including it in their current year income[8]. To illustrate this principle, we can consider a company who has purchased some laptop computers to give as a raffle prize for a new marketing campaign in regards to an upcoming product launch. The company will receive a full deduction for the cost of the laptops as a marketing expense. Now suppose that a year later, the product is scrapped and the laptops are instead given to some of the employees to keep. Under tax benefit theory, the change in circumstances for the use of the laptops should be reflected through an income inclusion for the employees who received them. In the case of the frequent flyer programs, the points earned through business travel should really be reflected as a reduction in future business travel expenses claimed by the company through a bargain purchase. Instead, the points are accumulated in the employee's personal account and are used to reduce the cost of their own personal travel. The change in circumstances around the use of the points should really be accounted for as an income inclusion for the employee.

Alternatively, Cunningham proposes that these benefits should actually be treated as prizes and awards rather than employment income after scrutinizing the language and terms of

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[6] Cunningham, J. "Are Frequent Flyer Benefits Really Benefits?: An Analysis of the Frequent Flyer Tax Debate and a New Theory of Taxability for Frequent Flyer Benefits." *Cleveland State Law Review*, 47.(1999)
[7] George Guttman, IRS Moves Slowly on Frequent Flyer Issue, 38 TAX NOTES 1309 (1988)
[8] Joseph M. Dodge Et Al., Federal Income Tax: Doctrine, Structure and Policy 777 (2d ed. 1999)

the frequent flyer miles programs[9]. Cunningham asserts that the language in the membership literature and promotional materials suggest that the benefits realized from any frequent flyer program are the disbursements of awards and/or prizes, regardless of whether they are earned in a business or personal context[10]. She supports this by looking to two of the largest American frequent flyer programs, United Airlines Mileage Plus and American Airlines AAdvantage which describe each of the benefits received as “rewards” or “mileage bonuses” respectively. The treatment of these benefits as a prize and award is also supported by the terms of the membership agreement as well. There is no true contract between the airline and the frequent flyer member that will force the performance of the services as airlines can revoke earned miles and cancel privileges at any time. This would leave members with little recourse if they are not able to exercise their points for free benefits. Based on this analysis, the disbursement of flight rewards appear to be completely discretionary and should be treated as such under the Income Tax Act.

While Cunningham’s proposal is based on including frequent flyer benefits as awards under Section 74 of the Internal Revenue Code in the U.S., the laws and definitions are slightly different when taken in the Canadian context. While employer-provided awards are non-taxable per the CRA, there is a specific set of criteria that must be met in order for the disbursement to meet the definition of an “award”. Namely, the award must be for an overall contribution to the workplace, have clearly defined criteria, a nomination and evaluation process, and a limited number of recipients[11]. Due to the fact that frequent flyer miles are not earned based on contributions to the workplace, they will not be able to meet this criteria. Instead, the award

[9] Cunningham, J. "Are Frequent Flyer Benefits Really Benefits?: An Analysis of the Frequent Flyer Tax Debate and a New Theory of Taxability for Frequent Flyer Benefits.", *supra note 6*
[10] Ibid.
[11] "Rules for gifts and awards."*Canada Revenue Agency*, 19 Mar. 2014. Web. 8 July 2014. <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/pyrll/bnfts/gfts/plcy-eng.html>.

would be more analogous to an award from a manufacturer to the company that has been passed to the employee. In these cases, the CRA has taken the position that these benefits should actually be included as employment income instead[12].

CURRENT TAX LAW ON CUSTOMER LOYALTY PROGRAMS

Section 6(1) of the Canadian Income Tax Act (ITA) requires that the value of benefits received or enjoyed by a taxpayer, or a person who does not deal at arm's length with the taxpayer, by virtue of the taxpayer's employment, be included in the taxpayer's income for the year[13]. Although paragraph 6(1)(a) of the ITA provide specific exceptions to the types of benefits that do not need to be included in a taxpayer's income, no reference is made to the exclusion of loyalty programs as taxable benefits[14]. In the case of *Mommersteeg et al. v. The Queen*, the taxpayers received flight tickets as a result of frequent flyer points accrued on reimbursed business travel[15]. After reviewing section 6(1) of the ITA, the courts believed that the scope of benefits that fell within the definition of taxable benefits was very broad[16]. The courts concluded that by using the ordinary meaning of the language used within section 6(1), it is undeniable that free flight tickets received by taxpayers through a frequent flyer program as a consequence of their employment constitutes as a taxable benefit[17]. By similar reasoning, it is clear that benefits acquired through the redemption of points in a loyalty program, by virtue of employment, are subject to tax and the value of the benefit must be included in the taxpayer's income for the year. The procedures for reporting employment benefits under loyalty programs depends on whether the employer is able to control the accumulation of points. For loyalty programs where the

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[12] "Awards from a manufacturer or promotional items."*Canada Revenue Agency*, 19 Mar. 2014. Web. 8 July 2014. <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/pyrll/bnfts/gfts/mnnfctrr-eng.html>.

[13] "Canadian Income Tax Act with Regulations, Annotated", 96th ed. *CCH Canadian Limited*, Toronto, 2013, p. 7-8.

[14] Ibid.

[15] "Mommersteeg et al. v. The Queen", 6 DTC 1011; [1995] 2 CTC 2767.

[16] Brown, W.G. Tad, and David Wentzell."Current Cases."*Canadian Tax Journal*: n. pag. Web. 3 June 2014.

[17] Ibid.

employer is able to control the accumulation of points, the CRA has stated that it is the employer's responsibility for including the fair market value of those benefits on their employees' T4[18]. Due to the inclusion of these benefits on the employees' T4 slips, the CRA's matching program allows it to locate unreported income[19]. As a result, reporting of employment benefits under loyalty programs where employers do control the accumulation of points is likely not a huge concern as the CRA is able to verify the taxpayers' reported income with T4s received from a third-party source.

Alternatively, if the employer does not control the accumulation of points, as is the case for frequent flyer programs where the airlines typically control the distribution and redemption of points, the CRA has taken the view that employment benefits related to these loyalty programs do not need to be included in the taxpayer's income provided that:

- "The points are not converted to cash;
- The plan or arrangement is not indicative of an alternate form of remuneration; and
- The plan or arrangement is not for tax avoidance purposes"[20].

However, if any of the above three conditions are met, the onus is on the employee for including the fair market value of the benefits in his/her income for the taxation year. This paper will focus on the taxation of loyalty programs where the employer does not control the accumulation of points, as self-reporting of employment benefits undoubtedly encounter higher non-compliance rates.

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[18] Ferguson, Rita. "Loyalty Programs- Technical Interpretation 2010-0353041E5.", *Canada Revenue Agency*, 15 June 2010

[19] Golombek, Jamie. "CRA on hunt for unreported income."*Financial Post*, 19 Sept. 2013, sec. Business: D4. Web. 6 June 2014. <http://www2.canada.com/edmontonjournal/news/business/story.html?id=3d8e4872-982a-4c9c-87ee-9823483cc8be>.

[20] "Income Tax Technical News No. 40."*Canada Revenue Agency*, 11 June 2009

COMPARISON OF CANADIAN LAW WITH OTHER JURISDICTIONS

The CRA's current view on the taxation of loyalty programs in Canada is quite similar to those of other jurisdictions. In particular, the Internal Revenue Service (IRS) of the U.S. made an announcement in 2002 that it would not pursue taxpayers who do not report personal receipt of frequent flyer miles or other "promotional benefits" obtained by virtue of their employment[21]. Similar to Canada, these benefits must be reported if they are converted to cash or are for tax avoidance purposes[22]. Although the IRS has taken the position that it would not pursue taxpayers, the IRS's guidance over frequent flyer miles and benefits from loyalty programs is vague since it makes no reference as to whether these benefits are taxable by law.

The case of *Charley v. Commissioner* was the first ground breaking case regarding the taxation of customer loyalty programs in the U.S. The decision from the case provides an important basis for the current law, which states that customer loyalty points that are converted to cash are in fact subject to tax.

The facts of the case are as follows: The appellant, Mr. Charley, was the owner-manager of Truesdail Laboratories, a company involved with medical lab work and testing. As a part of his job, he was required to travel extensively to different client locations allowing him to earn frequent flyer miles on his travel expenditures. Mr. Charley devised a scheme that allowed him to effectively convert these frequent flyer miles earned through business travel into cash that was deposited directly to his personal account[23]. He achieved this through a series of steps. When required to travel for work, he would book an economy class ticket. Next, he would use his existing points in order to "upgrade" his ticket to a business class ticket and bill the client for the

[21] "Announcement 2002-18: Frequent Flyer Miles Attributable to Business or Official Travel." *Internal Revenue Service*, 20 Feb. 2002. Web. 3 June 2014. <http://www.irs.gov/pub/irs-drop/a-02-18.pdf>.
[22] Ibid.
[23] Charley v. Commissioner, United States Court of Appeals No. 94-70043 (1996).

full value of a business class ticket. The end result was that Mr. Charley was able to convert his frequent flyer miles into cash equal to the difference between the value of an economy and business class ticket. The key question here was whether these cash proceeds from his conversion scheme constituted as taxable income. The tax court found that these proceeds constituted "gross income" which the appellant court confirmed[24].

The decision was important because it definitively addresses one aspect of frequent flyer miles – namely that the sale of such points would constitute income. The problem is that it misses the crux of the problem and the court did not comment on whether the employer provided frequent-flyer miles constituted as income in general. This is one reason why the current IRS rules surrounding frequent flyer miles are vague.

It is important to note, however, that the IRS is considering a proposal to introduce a new set of corporate tax rules over loyalty programs[25]. Whether a corresponding set of personal tax rules will be implemented to tax loyalty programs remain unknown. No additional announcements have been made since the date this paper has been submitted. If additional time is allotted, we plan on further investigating these rules as they are announced.

Australia also follows similar protocol over the taxation of flight awards and rewards received from consumer loyalty programs. In the case of *Payne v. FC of T*, the courts ruled that the taxpayer's flight rewards, arising as a consequence of employment, did not need to be included in her income[26]. Following the court's decision, the Australian Taxation Office (ATO) subsequently issued Tax Ruling (TR) 1999/6 and Tax Determination (TD) 1999/34 which states

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[24] Charley v. Commissioner, *supra note 23*

[25] Leff, Gary. "The IRS Looks To Be on the Verge of Imposing a Big Tax Burden on Loyalty Points." *View from the Wing*, 23 May 2014.Web. 3 June 2014. <http://viewfromthewing.boardingarea.com/2014/05/23/irs-appears-considering-new-rule-start-taxing-loyalty-points/>.

[26] "PS LA 2004/4 (GA) -Income tax and fringe benefits tax - rewards received under consumer loyalty programs." *Australian Taxation Office*, 14 July 2004. Web. 3 June 2014. <http://law.ato.gov.au/atolaw/view.htm?docid=PSR/GA20044/NAT/ATO/00001>.

that rewards under consumer loyalty programs are taxable if the reward is received as a consequence of employment and

- There is a business relationship between the taxpayer and the program provider; and
- The rewards are convertible to money or "money's worth"; or
- The taxpayer is carrying on a business and section 21A of the Income Tax Assessment Act 1936 (ITAA 1936) requires the value of the benefits be included in the taxpayer's income[27].

The ATO also has the right to assess the taxability of benefits under other loyalty programs if the rewards represent a substantial personal benefit to the taxpayer or if the rewards have a "sufficient and material connection to employment" (i.e., the rewards take on the form of being an alternate form of remuneration)[28].

In addition to the above rules over consumer loyalty programs, TR 1999/6 also specifically considers frequent flyer programs, stating that flight rewards are generally not taxable unless:

- "The employer and employee have a family relationship and the flight reward is received in connection with the employment"; or
- The flight reward arose from business expenditures but is received by the employee "under an 'arrangement' for the purposes of the Fringe Benefits Tax Assessment Act (FBTAA)". In other words, the reward can be seen as an act of tax avoidance; or

[27] "PS LA 2004/4 (GA) -Income tax and fringe benefits tax - rewards received under consumer loyalty programs.", *supra note 26*
[28] Ibid.

- The individual received the flight reward with an understanding that it would be received as a consequence of his/her employment. That is, the flight reward appears to be another form of the individual's remuneration[29].

South Africa's Minister of Finance recently released its 2013 Budget Speech and indicated the country's need to promote economic growth by expanding its tax base[30]. As a result, researchers Pidduck and Odendaal subsequently assessed the country's current legislation and investigated ways the South African Revenue Service (SARS) can increase the tax base by changing the tax treatment of customer loyalty programs. The authors' focus in the paper was broader and investigated methods on taxing customer loyalty award credits, whether they were obtained personally or as a consequence of employment[31]. However, they note that South Africa's current legislation do not tax customer loyalty credits[32]. Section 2.4.8 of the guide to taxation in South Africa published by the SARS outlines the taxation of taxable benefits and discusses common taxable benefits such as allowances, interest-free loans, and benefits in kind (e.g., use of a company-owned motor vehicle) in accordance with the South African Income Tax Act 58 of 1962[33]. No mention was made as to the taxability of rewards obtained from customer loyalty programs by virtue of employment. It is clear that South Africa is one of the many countries that have yet to devise a way to tax customer loyalty program rewards/credits obtained by a taxpayer as a consequence of his/her employment.

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[29] "PS LA 2004/4 (GA) -Income tax and fringe benefits tax - rewards received under consumer loyalty programs.", *supra note 26*

[30] Pidduck, Teresa Calvert, and Karen Odendaal. "Customer Loyalty Programmes: The Loss To The Fiscus In South Africa." *International Business & Economics Research Journal* 12: 1521-1534, December 2013. Web. 8 July 2014. <journals.cluteonline.com/index.php/IBER/article/download/8247/8283>

[31] Ibid.

[32] Ibid.

[33] South African Revenue Service."TAXATION IN SOUTH AFRICA 2013/14."*South African Revenue Service*, 1 Mar. 2014. Web. 8 July 2014. <http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-Gen-G01%20-%20Taxation%20in%20South%20Africa%20-%20External%20Guide.pdf>.

In this regard, it appears the CRA's stance on the taxability of rewards received under loyalty programs as a consequence of employment is consistent with that of the taxation authorities in several other countries. Our research to date has not revealed any countries that have successfully taxed rewards from customer loyalty programs received by virtue of employment. If additional time is permitted, we plan on further assessing the tax law of other countries and identifying any potential differences they have with the Canadian tax system.

EVALUATION OF CURRENT TAX LAW

Although the current tax policy is consistent with that of many countries, it does not satisfy the concept of horizontal and vertical equity.

Violation of Horizontal Equity

The concept of horizontal equity states that taxpayers with an equal amount of utility should pay an equal amount of taxes[34]. Consider the situation where two employees, say Employee A and Employee B, earn identical salaries and are both required to travel extensively as part of their employment. However, Employee A is a member of a frequent flyer program where he accrues points which he can redeem for personal flights. Employee A's employer is not in control of the accumulation of points in his frequent flyer program. In comparison, the frequent flyer points earned from Employee B's business travel are accumulated in the employer's corporate frequent flyer account. As such, Employee B's employer maintains control over the accumulation of points but gives Employee B the ability to redeem these points for personal travel once a year. Suppose both Employee A and B was able to redeem their points in these programs for an identical flight to California for a vacation. Note that Employee A will not be taxed on his frequent flyer points which he uses for personal enjoyment, whereas the value of Employee B's flight ticket will be included in his T4 by the employer. Clearly, both employees

[34] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals", *AICPA*, Mar. 2001, p. 7-12

enjoyed the same benefits and are in similar circumstances, yet, Employee B would end up paying higher taxes due to the income inclusion of his employment benefit. The absence of a tax on loyalty programs where the employer does not control the accumulation of points clearly represents a violation of horizontal equity.

Violation of Vertical Equity

Another one of the guiding principles of tax policy-setters is the concept of vertical equity where persons with greater utility should pay more tax[35]. Consider a similar situation where Employee C and Employee D earn identical salaries, but only Employee C is required to travel extensively for business purposes. Employee C is a part of a frequent flyer plan where the employer does not control the points. As a result, Employee C is able to accrue points which he can redeem for personal flights. In comparison, Employee D does not travel for business purposes at all. Suppose Employee C redeems his points in the current taxation year to obtain a flight ticket to California for a vacation. Note that Employee C will not be taxed on his frequent flyer points which he uses for personal enjoyment since the employer does not control the accumulation of the frequent flyer points. It is clear that Employee C experienced a higher level of utility due to his consumption of a frequent flyer ticket and that he should pay more taxes. Yet, both employees would result in paying the same amount of tax. The absence of a tax on such loyalty programs clearly represents a violation of vertical equity.

TRADITIONAL APPROACH

Prior to 2009, the CRA has taken the view that it is the responsibility of the employee to include in income the fair market value of any benefits received under a loyalty program where

[35] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals", *supra note 34*

the employer did not control the accumulation of points[36]. That is, employment benefits under loyalty programs are taxable regardless of the nature of the benefits (e.g., non-cash rewards such as flight tickets). However, the CRA encountered low compliance rates due to a violation of the tax policy objective of uncertainty. In particular, there were significant concerns over valuation and timing, as well as monitoring the reporting of these benefits[37].

Uncertainty - Valuation

The taxation of employment benefits received under loyalty programs has historically encountered concerns regarding the valuation of these benefits. Consider again, the 1995 case of *Mommersteeg et al. v. The Queen*, where the taxpayers received flight tickets as a result of frequent flyer points accrued on reimbursed business travel[38]. Pursuant to the tax law prior to 2009, the tickets represented a taxable benefit that must be included in the taxpayers' incomes. The minister's position is that the highest price of an economy, business, or first class ticket that was sold for the same flight should be used as a proxy for the taxable value of the reward ticket[39]. However, the court acknowledged that reward tickets often consist of significant restrictions and that care must be taken in determining the value of such tickets[40]. These restrictions are primarily onerous in nature and hence, when determining the value of a reward ticket, a discount must be applied to reduce the taxable value of the tickets. The court's discussion revolved around three classes of tickets: economy, business, and first class. Prices of economy tickets can fluctuate considerably depending on when the tickets were booked and the applicability of special offers. The court concluded that it is unlikely for an economy reward

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[36] "IT-470R: Employees' Fringe Benefits", *Canada Revenue Agency*, 6 Sept. 2002. Web. 3 June 2014. <http://www.cra-arc.gc.ca/E/pub/tp/it470r-consolid/it470r-consolid-e.html#P128_12793>.
[37] Oliveira, Darrell. "THE TAXABILITY OF FREQUENT FLYER CREDITS EARNED BY EMPLOYEES: WHY THE IRS HAS REMAINED SILENT ON THE ISSUE.": 3. Web. 3 June 2014.
[38] "Mommersteeg et al. v. The Queen", *supra note 15*
[39] Ibid.
[40] Ibid.

ticket to have a fair value greater than the most heavily discounted economy ticket sold on the same flight[41]. As such, the court believed that the taxable value of economy reward tickets should be the value of the most heavily discounted economy ticket sold for the flight[42].The court's reasoning is that "the proper measure of the value of a benefit in the form of a reward ticket is the price which the employee would have been obliged to pay for a revenue ticket entitling him to travel on the same flight in the same class of service and subject to the same restrictions as are applicable to reward tickets"[43]. By similar reasoning, the court tries to address the valuation of business and first class reward tickets which may also have similar onerous restrictions attached. Because business and first class tickets are rarely discounted, it is difficult to determine the value of the most heavily discounted business or first class ticket. As such, the court established a separate set of tests in which the taxable value of a business or first class reward ticket is determined by multiplying the normal value of a business or first class ticket by the ratio of the most heavily discounted economy ticket over the full price of the same economy class ticket[44]. Although the court's valuation approach is equitable as it takes into account that reward tickets are often used to fill seats that the airline would not have sold, the aforementioned calculation may be impractical[45]. The value of flight tickets fluctuate wildly based upon many variables, and the only party who is aware of the discounted prices of all the tickets it has offered to customers is the airline company itself. Undoubtedly, airline companies will object to disclosing such information to taxpayers in determining the taxable benefit of their reward tickets. This is because such a disclosure reveals competitive information and may result in complaints among customers who have paid substantially more for the same flight ticket than

[41] Brown, W.G. Tad, and David Wentzell."Current Cases.", *supra note 16*
[42] Ibid.
[43] "Mommersteeg et al. v. The Queen", *supra note 15*
[44] Ibid.
[45] Brown, W.G. Tad, and David Wentzell."Current Cases.", *supra note 16*

another customer[46]. As a result, the court's position is valid in theory, but is impractical for individual taxpayers to apply when trying to determine an appropriate value to assign to frequent flyer reward tickets as they do not have access to the necessary information[47]. Taxpayers may make an attempt to research the different prices of their redeemed flight ticket online from the websites of travel agencies and airline companies, but it is impossible for them to determine whether the quoted price is the most heavily discounted price for a ticket of the same class. In addition, different travel agencies may offer different prices, and prices may change on a daily basis. Hence, even if the taxpayer makes a reasonable attempt to comply with the court's valuation rules as set out in the case of *Mommersteeg et al v. The Queen*, the results will undoubtedly be inaccurate and vary across different taxpayers performing the same task, resulting in a violation of horizontal equity. Similar reasoning may be applied to rewards received under other loyalty programs where the conversion rates of the loyalty points differ depending on the reward chosen. Hence, the valuation of rewards obtained through loyalty programs remain a prevalent obstacle in solving the issue of taxing loyalty programs.

Uncertainty - Timing

In the case of *Mommersteeg et al. v. The Queen*, the court also raised a question as to whether benefits under loyalty programs should be taxed when the points are received, or when the points are redeemed[48]. This issue is of lesser concern as the court acknowledged that there would be significant outrage if taxpayers are taxed on the receipt of such points as the points may never be redeemed.

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[46] Brown, W.G. Tad, and David Wentzell."Current Cases.", *supra note 16*
[47] Ibid.
[48] "Mommersteeg et al. v. The Queen", *supra note 15*

Monitoring

For loyalty programs where the employer does not control the accumulation of points, the tax law prior to 2009 required self-reporting of these employment benefits. Because the CRA was unable to pursue confirmation with third parties, as is the case where employers do control the accumulation of points and the benefits are reported on an employee's T4 slip, the CRA experienced significantly low levels of compliance[49].

Because of these issues, the CRA relaxed its stance in 2009 and introduced the three conditions where employment benefits received under these loyalty programs are only taxable if the points are converted to cash, is an alternate form of remuneration, or used for tax avoidance purposes[50].

In light of these concerns over the traditional approach and the poor design of the current tax rules over loyalty programs, the remaining portion of this paper will discuss a few alternatives, and evaluate them against the objectives of tax policy.

DAHER'S PROPOSED METHODS OF TAXATION

In his article, Daher argues that frequent flyer miles should be included in income in order to meet the "fairness" canon of taxation[51]. He asserted however, that the current standards in Treasury Regulation §1.61-21(b)(1) was too vague and unclear to allow for practical implementation of an equitable taxing system. As stated, Treasury Regulation §1.61-21(b)(1) outlines the following standard for valuation of the taxable benefit related to frequent flyer miles:

> An employee must include in gross income the amount by which the "fair market value" of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount, if any specifically

[49] Ozeroff, Tony. "Employee Taxable Benefits: Recent Policy Changes." *Collins Barrow*, 15 Jan. 2010. Web. 3 June 2014. <http://www.collinsbarrow.com/en/cbn/publications/employee-taxable-benefits-recent-policy-changes>.
[50] "Income Tax Technical News No. 40.",*supra note 20*
[51] Daher, Dominic. "The Proposed Federal Taxation of Frequent Flyer Miles Received From Employers: Good Tax Policy But Bad Politics." *Akron Tax Journal* 16: n. pag. Web. 7 July 2014.

> excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986.[52]

Daher instead proposes a simpler method of using a flat rate of $0.01 per mile used for personal benefits. As a result, an employee would simply have to multiply the number of employer-generated miles used in any given year by a factor of $0.01 in order to arrive at the benefit that should be included in income.

In terms of timing, Daher believes that the theoretically correct treatment for frequent flyer miles is to require the income inclusion at the time the miles are actually earned, since this is the time that the employer is receiving the deduction for the business travel expenses. Daher also states however, that it would be too administratively difficult to implement this, and as a result, the benefit should instead be taxed at the time the miles are actually redeemed.

In order to implement this, companies must have a way to effectively separate frequent flyer miles earned from personal expenses versus business expenses. Under the Daher proposal, it would be the responsibility of the airline company to keep track of the separate miles and all companies would be required to submit a written statement to airlines they employ that outline their policies on frequent flyer miles. To facilitate the segregation of miles, Daher states that airlines should accrue miles for any ticket purchased directly by a corporation to the business account of the named traveller.

In order to ease the transition to his new standard, Daher concedes that all existing miles at the effective date of his proposed standard should be treated as personal and non-taxable and the standard should be applied prospectively. Daher also proposes that airlines directly report the amount of frequent flyer miles redeemed to the IRS to increase compliance rates with the assistance of third-party reporting.

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[52] "eCFR — Code of Federal Regulations." *eCFR — Code of Federal Regulations*. US Government Printing Office, 3 July 2014. Web. 8 July 2014. <http://www.ecfr.gov/cgi-bin/text-idx?rgn=div8&node=26:2.0.1.1.1.0.2.17>.

Analysis of the Daher Proposal

Daher's proposal definitely presents a step in the right direction for the eventual taxation of frequent flyer miles but fails to address several important issues that have prevented lawmakers from addressing this in the past.

Firstly, Daher proposes a standardized flat rate of $0.01 per mile in order to determine the value of the ticket realized. This ignores the fact that frequent flyer miles can be redeemed for a wide variety of rewards - not just flights. Furthermore, based on our results in Appendix A, this flat rate will result in under-valuation of the tax liability associated with non-flight rewards. As a result, this method in itself will violate the concept of horizontal equity since two employees who receive the same value of benefits may have different tax liabilities because the value of the income inclusion is only based on the number of miles redeemed versus the actual fair value of the reward received.

Secondly, Daher suggests that airlines should segregate employer generated business miles from personal miles at the time the ticket is purchased by determining who is purchasing the ticket. In his proposal, he states that if the airline ticket is purchased by the corporation, then any resulting miles should be accrued as business miles. This strategy does not consider the situation where employees purchase the ticket themselves and later get reimbursed by the employer. If the Daher standard were to be implemented, employers can easily change their policy to allow the employee to purchase the ticket directly and reimburse them later in order to avoid the tax consequences of including it in income.

Aside from this, Daher makes good points that should be considered for any successful taxation system. Namely, that the timing of the income inclusion should be at the time the points are redeemed to avoid imposing unfair tax liabilities on individuals who never end up using the points for any benefits. Additionally, any future law that attempts to address this must consider an appropriate treatment for the transition period. Applying it prospectively appears to be the only feasible method considering the impracticalities of determining how to split existing miles from personal and business. Lastly, any successful system must incorporate some kind of third party reporting to increase compliance rates in order to achieve equity amongst taxpayers.

A POTENTIAL SOLUTION TO THE TAXATION OF FREQUENT FLYER MILES

One of the most important features a new system should have is the ability to track points earned from personal expenses separate to those earned from business expenses. This follows from the previous discussion that points earned on personal expenses are part of a tax-free bargain purchase, whereas points from business expenses are taxable benefits according to tax benefit theory. As a result, the first step in accurately monitoring the accumulation of points in individuals' customer loyalty accounts is to separate points into two different pools: business or personal, as opposed to the current system of tracking it as a lump sum total. Using this approach, customers should be required to specify the nature of their travel as business or personal at the time the flight ticket is purchased. Once this is completed, the points that the customer receives from their frequent flyer program can be credited to the appropriate pool as business or personal miles in the supplier's database. This shifts the onus of tracking miles to the rewards program supplier which will greatly improve accuracy and objectivity.

Once the rewards program supplier is able to accurately separate business points and personal points, the system can be used to solve the valuation and timing problems as well. When individuals redeem points, both parties to the transaction will know exactly how many points used were business points and how many were personal. This can be used to determine the value of the taxable benefit transferred to the user by calculating the proportion of the value of the flight funded by business points. This can be illustrated with a simple example. Suppose person A has 500 personal points and 500 business points and redeems all 1000 points to purchase a personal round trip ticket from Toronto to Montreal. If the cost of the equivalent ticket would have been $500 for the specific dates and class specified, then we can see that person A has enjoyed a benefit of $250 because half of the cost of the ticket was funded by his business points. At the end of the year, the rewards supplier will issue a statement to users who have redeemed business points and the allocation of the fair value of the flights received. This information will also be reported directly to the CRA to help improve compliance.

Although this proposal has been discussed in conjunction with frequent flyer programs, the same system can be used for all other customer loyalty programs. Rewards from customer loyalty programs received by virtue of employment can be taxed, provided that corporate and personal points can be segregated and tracked by the program provider.

EVALUATION OF PROPOSED ALTERNATIVE AGAINST TAX POLICY GOALS

Neutrality

In order to assess the neutrality of our proposal, we must consider whether its implementation will change the behaviour and decision making of individual taxpayers. Consider a hypothetical person who is required to travel extensively for business purposes. Under the new system, customer loyalty points generated from business travel will be tracked separately and will generate taxable benefits when redeemed. In order to avoid these adverse tax consequences, the employee will try to use alternate methods of transportation which can provide him with personal non-taxable benefits. As a result, he may be tempted to use alternative methods of transportation such as trains or busses which also offer some kind of a customer loyalty program. However, the end result should be the same because theoretically, any customer loyalty programs for train or vehicular format can also be modified to track taxable benefits just like frequent flyer programs. Therefore the taxpayer achieves nothing and the system is neutral. If rewards providers do not track loyalty points for train or vehicular transportation the same as in air travel, then the individual could avoid taxes by switching to these alternate forms of transportation. However, they would have to consider the drawbacks of longer transportation times, potentially reduced comfort and other non-tax factors.

In order to entice new customers, airlines can instead start offering other types of rewards such as in flight food and beverage discounts or small gifts instead of points to avoid customers having to face a tax liability. In these cases, neutrality will fail because customers will be able to avoid taxes by opting to receive non-point rewards since the system is only able to track rewards points redeemed for personal use. However, taxpayers will have to consider the drawback of receiving these smaller gifts as it may be more valuable to collect points to exchange for personal flight tickets.

Horizontal Equity

In evaluating horizontal equity, once again consider the example involving Employees A and B where they both earn identical salaries. As a reminder, frequent flyer points accrued from Employee A’s business travel accumulates in his personal account and his employer does not control the accumulation of points. Alternatively, frequent flyer points accrued from Employee B’s business travel accumulates in the employer’s corporate account and his employer does control the accumulation of points. Under the proposed approach, Employee A will continue to accrue frequent flyer points, but these points will accumulate in his corporate pool. If these corporate points are redeemed for a personal trip, the airline company would issue a tax slip to Employee A and subsequently report the amount to the CRA. As a result, Employee A will be taxed on this employment benefit. Likewise, Employee B will continue to be taxed on this amount as his employer would report it on Employee B's T4. Hence, both individuals who were situated in similar circumstances would pay the same amount of taxes and this is in line with the concept of horizontal equity.

Vertical Equity

In evaluating the proposed approach under vertical equity, again consider the illustration involving Employees C and D where both earn identical salaries. In this example, Employee C is required to travel extensively for business purposes and partakes in a frequent flyer program where points earned on business trips may be redeemed for personal travel. On the other hand, Employee D is not required to travel for the purposes of his employment. Assuming all other things equal, if Employee C redeems a flight ticket for vacation using his corporate pool of frequent flyer points accrued on business trips, his utility and ability to pay is higher than that of Employee D. Under the proposed alternative, the airline would properly value and report Employee C's California flight ticket as an employment benefit through the issuance of a tax slip to Employee C. This ensures that Employee C, the individual with the higher ability to pay, is indeed paying more taxes in comparison to Employee D. That is, vertical equity is maintained.

Uncertainty - Valuation

The proposed alternative attempts to ease some of the concerns over the valuation of employment benefits received from customer loyalty programs since the program provider (e.g., the airlines) are responsible for reporting the value of the benefit to the taxpayer. This makes it clear to the taxpayer as to the amount that they must report on their annual tax return. Furthermore, the program provider has access to significantly more information that will allow them to value the benefit conferred upon the taxpayer. In particular, airlines are easily able to determine the value of a flight ticket obtained through frequent flyer points by quoting the value of an identical flight ticket that it may be offering to other customers. The information asymmetry that exists between taxpayers and program providers make it difficult for taxpayers to self-report their employment benefits as experienced by the CRA under the traditional approach. The proposed alternative is able to circumvent this obstacle by placing the burden of valuation on program providers who have access to the resources necessary to perform this task.

Although the proposed alternative places the burden of determining the value of any taxable benefits conferred upon taxpayers in the hands of the program providers, there may still be multiple prices charged by the program provider, during its ordinary course of business, for goods or services members have redeemed under their loyalty programs. For instance, an airline company may have charged multiple customers different prices for a ticket of the same class and of the same flight. This was acknowledged by the court in the case of *Mommersteeg et al v. The Queen* where the court found that airline companies would charge multiple prices for the same economy class flight ticket[53]. Hence, program providers may have difficulty in determining amounts to report on the tax slips that it would be obligated to issue to its members who received taxable rewards during the year.

Flight Rewards

One of the potential solutions to this problem has been presented in the case of *Mommersteeg et al v. The Queen*. As explained previously in this paper, the court has established that the lowest price offered on a flight should be used as a proxy for the valuation of economy class reward tickets. In computing the taxable benefit value of business and first-class reward tickets, the court established a separate set of rules where an adjustment, derived using the highest discounted price of an economy ticket, is applied to the normal price of a business or

[53] Mommersteeg et al. v. The Queen", *supra note 15*

first-class ticket[54]. By enforcing the court's conclusion as case law, airline companies would have a method in computing the taxable benefits conferred upon its members under the proposed alternative. That is, taxable benefits conferred under frequent flyer programs would all be valued at the lowest price of the good that the program provider has offered to external customers in its normal course of operations.

Non-Flight Rewards

Under most customer loyalty programs, members are also given the ability to redeem non-flight rewards. The rewards provider will have to track the fair value of the goods/services redeemed in order to report the fair value of rewards to include in income. This may be difficult to administer since it may pose large costs on program providers to track small rewards or gifts with nominal amounts. As demonstrated in Appendix A, frequent flyer programs offer a large variety of non-flight options, each with varying fair values. It is unclear if it would be difficult for airlines to track the fair values of the rewards disbursed. Because these goods are often provided by the program provider through partnerships or affiliations with external companies (such as Panasonic for the televisions), the correct value to be assigned to taxable benefits involving these rewards should be the recommended retail value of the good or service. This is consistent with the court's reasoning in the Mommersteeg case because the retail price is the amount that a taxpayer would normally be expected to pay if he/she were to purchase the good or service externally. It should be mandated that the retail value of goods or services offered by a program provider be obtained through communication with the external partner or affiliate that is providing these goods or services. However, depending on the size of the program provider and the resources it has available, tracking the recommended retail value for each reward may not be feasible. If the values cannot be tracked, then this would violate the principles of horizontal

[54] Mommersteeg et al. v. The Queen", *supra note 15*

equity since the proposed system can only objectively work for the valuation of flight rewards. It would also create problems in terms of neutrality because taxpayers will try to redeem non-flight rewards in order to avoid reporting tax liabilities.

Lack of Information on Retail Values

The above noted valuation approaches to the taxable benefits can be a time-consuming exercise or improbable in instances where the retail value is not available or disclosed. This may be the case where a non-airline loyalty program provides reward flight tickets through a partnership with an airline company. Consider the case where Petro-Points can be redeemed for an Air Canada flight ticket. The retail value of the flight ticket, as extensively discussed in the preceding sections, cannot be readily determined given the range of prices that an identical ticket may be sold at. Airline companies would also be hesitant in disclosing the most heavily discounted price for a ticket of the same class and of the same flight to the gas company offering the program. Hence, in this case, the gas company would have no information to base the valuation of taxable benefits that may be conferred on its members. To mitigate this concern, the valuation of taxable benefits can be updated to include a special formula. For instance, "higher of" calculations can be implemented into the valuation exercise, where the higher of:

- The retail value of the good or service (most heavily discounted price for flight reward tickets), and
- A flat rate per loyalty point

be used to determine the value of the taxable benefit. The above represents a combination of the proposed alternative and the Daher approach discussed earlier. Although this incorporates additional complexity into the exercise, this is a valid approach in mitigating valuation concerns in the circumstances where a value for the taxable benefit in question cannot be readily determined by the program provider.

Uncertainty - Timing

The proposed alternative operates similarly to the traditional approach in regards to timing of the tax. That is, rewards from customer loyalty programs are taxed upon redemption and not on the receipt of the points. This is in agreement with the court's observation in *Mommersteeg et al. v. The Queen* where taxing individuals on the receipt of points is unfair since the points may never be redeemed[55].

Monitoring

Under the proposed alternative, the CRA will have less concern over monitoring the compliance of the taxable benefit rules on customer loyalty programs. This is because in the case of frequent flyer programs, if an individual redeems points from his corporate pool and uses it on a personal flight, the airline company would issue a tax slip to the taxpayer and subsequently forward a copy of it to the CRA. Taxpayers are no longer self-reporting these employment benefits and the CRA's matching system will allow it to locate any unreported employment benefits arising from customer loyalty programs.

Economic Growth and Efficiency

We acknowledge that the implementation of the proposed approach may require program providers to initially invest significant resources necessary to update their current IT systems to track taxpayers' personal and corporate points separately. This will likely hinder the operations of program providers, at least initially, and reduce the productive capacity of the economy. To ease the hostility that will likely be exhibited by program providers, the CRA can consider providing initial taxation relief to these corporations. If given additional time, we plan on

[55] "Mommersteeg et al. v. The Queen", *supra note 15*

evaluating the types of relief that may be feasible by reviewing any transitional relief provided on past implementation of new taxes and tax incentives that have been historically used to stimulate the economy.

Third-Party Reporting Requirements

The success of our proposal depends, in a large part, on the effectiveness of the third party reporting by airlines and customer loyalty program providers, and is consistent with Daher's proposal outlined earlier. It can be argued that imposing third party reporting requirements on these companies unfairly increases their costs.

Lederman proposes a set of six criteria that must be evaluated to justify the implementation of any third party reporting requirements[56]. Firstly, the transactions being reported must occur between arm's length parties. This is true in the context of the customer loyalty program providers and the employees and will increase the accuracy and compliance with reporting requirements. Second, the reporting entity should have some kind of bookkeeping infrastructure and be centralized. Both of these criteria are met since customer loyalty program providers already have the necessary infrastructure to accurately track member's points and redemptions. The reporting entity should also provide complete reporting, meaning that they should be able to provide all the information required to match the third party report to the employment inclusion on the employee's tax return. In our proposal, the employee will likely depend on the tax slip received from the customer loyalty program provider in order to determine the amount to report on their income tax return. This indicates that complete reporting will already be achieved in order for the employee to gain any value from it. Another criterion is that the third party reporting entity should have few alternatives to avoid reporting. This criterion

[56] Lederman, Leandra."Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?".*Fordham Law Review* Vol. 78, p. 1733, 2010; Indiana Legal Studies Research Paper No. 126.<http://ssrn.com/abstract=1347668>.

may not be completely met since the reporting entity can avoid reporting requirements by claiming that employees did not claim any employer generated miles, and rather, all the miles were actually personal miles. One potential mitigating factor is that companies who choose to do this will likely suffer negative publicity since they will be effectively assisting its members in evading taxes. Lastly, the tax gap eliminated by the reporting should be substantial compared to the additional costs imposed by reporting requirements. As demonstrated earlier, this criterion is likely met for frequent flyer programs since flights are typically high-value services and the sheer volume of the business-generated miles is quite high.

ADDITIONAL CONCERNS AND RESPONSES TO THE IMPLEMENTATION OF THE PROPOSED ALTERNATIVE

Non-Frequent Flyer Plans

The biggest drawback of our proposed plan is that it does not specifically address non-frequent flyer mile reward programs. For example, for plans such as the Petro-Points plan as described previously, it may be difficult for the rewards provider to separate business purchases from personal purchases since their products consist of small-value items such as gasoline, carwashes, etc. It would also be much too cumbersome to require the purchaser to constantly indicate whether the expense is a business expense versus a personal expense.

As a result, the public response to this would be to switch away from frequent flyer miles or other reward programs that are taxable to these programs that are not. This may result in a material loss of tax revenues. Furthermore it would violate horizontal equity to tax one program and not the other. There is potential to modify our proposal to cover other programs in the future, but the problem is that in most cases, the additional benefits will not justify added costs of compliance.

Reliability of Taxpayers' Declarations

As explained previously, the proposed alternative requires taxpayers to declare whether their travel is for business purposes or for personal purposes at the time a flight ticket is purchased. This declaration is critical in separating a taxpayer's corporate and personal pools of points. However, the proposed alternative only aims to tax loyalty points from a taxpayer's corporate pool if they were redeemed for personal purposes. Therefore, taxpayers will have a clear incentive to declare all of their flights as personal to avoid the future taxability of their loyalty points on redemption.

Because employees are often the ones purchasing their flight tickets for business purposes and are subsequently reimbursed by the employer, there is no third-party verification as to whether an employee correctly declared the nature of their flight purchase. Although this would be a clear violation of the law and an act of tax evasion, it would be difficult for the CRA to identify and apprehend individuals engaging in such practice.

Timing of Reward Consumption

The court has agreed in the Mommersteeg case in 1996 that if enforced, taxes on customer loyalty programs should be levied in the taxation year when points are redeemed for rewards[57]. However, there is an additional issue relating to the timing of when the rewards are consumed. Consider the case of frequent flyer miles, where miles are redeemed for flights that occur in the future. Suppose frequent flyer miles in the corporate pool are redeemed in December 2014 for a flight departing in April 2015. This is common as customers book flights well in advance of the trip. If the court's decision in 1996 over the timing of the tax is enforced under the proposed alternative, there would be a taxable benefit conferred upon the individual in his/her 2014 taxation year. However, under the proposed alternative, airline companies are responsible

[57] Mommersteeg et al. v. The Queen", *supra note 15*

for issuing tax slips to members under its loyalty program that had a taxable benefit conferred upon them as a result of a redemption of corporate points for personal flight tickets. In accordance with the valuation approaches discussed above, the value of a reward flight ticket is a function of the most heavily discounted flight ticket sold by the company for the same flight and class. It is clear that the airline company would not be aware of its most heavily discounted price on a particular flight until the flight actually occurs or when the sale of tickets for the flight have ceased. Due to the timing of the situation described, this may not occur until April 2015, whereas the taxable benefit is to be recorded on the taxpayer's 2014 tax return which is due by the end of April 2015. Hence, the amount on the corresponding tax slip to be issued to the taxpayer may not be verifiable by the airline company until after the taxpayer's return is due for a particular taxation year. This issue suggests that any taxable benefit should be included on the taxpayer's return when the goods are consumed. Yet, this would cause additional implications to arise, whereby taxpayer's may intentionally defer the "consumption" of a good or service received under loyalty programs that may be a taxable benefit. Furthermore, consumption of a good or service can be vague. For instance, how does one define the consumption of a television redeemed with corporate frequent flyer points? Taxpayers may argue that the benefit is conferred over the period of using the television in their homes and hence, the benefit should be taxed across a prolonged period of time. Clearly, taxing the benefit based on consumption opens up additional problems and is not in line with the current tax base of Canadian taxation. Hence, the only recommended approach to mitigating these concerns is to allow the inclusion of a taxable benefit to be deferred to the date of consumption for rewards where the date of consumption is clear and is a nature of the reward (e.g., flight reward tickets). All other rewards should continue to be taxed in the year when the loyalty points are redeemed.

Exchange of Points across Different Programs

Certain loyalty programs may offer points of another loyalty program as one of its rewards. For example, consider the case where Petro-Points can be converted to Asia Miles, an airline reward program where additional rewards are available. The proposed alternative requires each program provider to maintain a corporate and personal pool for all of its members. The conversion of points from one program to another may cause the distinction between the two pools to be lost if information is not exchanged between the two separate program providers. In this example, when a member converts his corporate or personal Petro-Points into Asia Miles, Petro-Canada must inform Asia Miles whether the Petro-Points were from the member's corporate or personal pool in order for the nature of the points to flow through from one program provider's records to another. However, in order for program providers to offer another program's points as one of its rewards, the two program providers must already have a channel of communication in place such that both parties' records are updated when a member engages in a conversion of points. As a result, although additional information sharing will be required to ensure each member's corporate and personal points are tracked when they flow from one program provider to another, the issue should not represent a significant hurdle if program providers make an honest attempt in accurately tracking its points.

Consumption of Rewards by another Individual

There may be instances where an individual redeems his/her frequent flyer points for a reward ticket which is subsequently consumed by another individual. For instance, this can occur when an individual possesses a large number of points. He subsequently redeems the points for a flight ticket for his spouse, who will be using it for personal travel. In this case, it appears that the ultimate benefit was conferred upon the spouse and should be taxable in her hands. However, this should not be the case as it is not in line with the current tax law. Consider a breadwinner model in which the head of the household earns income from employment to support his/her family of four individuals. The current Canadian taxation system taxes the breadwinner and not the other family members who also consume a portion of the breadwinner's income. Hence, although benefits from a loyalty program may be consumed by an individual other than the member, the benefits should be taxed in the hands of the individual who owned and redeemed the points.

Overbooked Flights

Another important situation to consider is the receipt of extra benefits on overbooked flights. Typically, when an airline overbooks a flight, they offer passengers who are willing to switch to a different flight some extra benefits for their inconvenience. This can be illustrated by the following simple example: suppose a flight is booked for 251 passengers but only has 250 seats. In order to entice someone to give up their seat, the airline offers a $200 credit on future flights. Typically, a passenger will volunteer to give up their seat in exchange for the credit. Now suppose the passenger who volunteered to give up their seat initially purchased their ticket using employer generated frequent flyer miles. How should the extra $200 credit be treated for tax purposes?

One answer can be found using discount theory explained earlier. The extra $200 credit can be seen as a discount on the cost of the ticket in terms of frequent flyer points. To illustrate this, consider Person A who purchases a ticket for $1500, and Person B who purchases the same ticket at $1500 but also receives a $200 credit from the same overbooked flight. Therefore the net cost for Person B is effectively $1300 and the credit does not represent a taxable event since it is most analogous to a purchase discount for voluntarily accepting the inconvenience of switching to another flight. From the viewpoint of Person B, $200 is adequate compensation for this added inconvenience. This effectively treats the extra credit as a separate agreement between the passenger and the airline. Applying this logic to frequent flyer miles, the $200 credit for a person who purchased the original ticket using frequent flyer miles can also be seen as a purchase discount and should generate no tax consequences. This appears to be reasonable because this is also why a person who purchases an economy class ticket for $1500 does not experience a taxable gain compared to a person who purchases a business class ticket for $2500 because the person with the economy class ticket is experiencing a discount due to a lower level of amenities, convenience and comfort on the flight.

The problem with this argument however is that the miles that were used to purchase the original ticket were also a benefit that was gained without any cost to the employee. As a result, application of the discount theory may not be appropriate in these circumstances, and the argument breaks down.

Alternatively, from applying tax benefit theory, we can see that the $200 credit represents an increase in the fair value of the benefits derived from the employer generated miles. This effectively treats the extra credit as a part of the original agreement involving the frequent flyer miles. As a result, the extra credit should be added to the fair value of the ticket which is to be reported in the employee’s income for the year.

While this might be the most theoretically correct treatment for the extra $200 credit, it is very difficult to administer. In order to be able to report the additional benefits, airlines would have to keep track of each of these credits awarded and determine if the original ticket was purchased using business generated miles or not. This can be further complicated if the original ticket was purchased with a combination of personal and business miles or cash and business miles because the value of the ticket would have to be allocated to each form of payment in some way. The next issue would be timing. Should the reward be recognized at the time it is awarded or redeemed? If the passenger never gets the chance to redeem the ticket in the future, it would be unfair to impose this additional tax liability, and would violate the concepts of horizontal equity. But deferring recognition until redemption imposes additional costs on airlines who must keep track of these rewards and identify them when they are redeemed to comply with reporting requirements. In many cases, these awards might be nominal, which would leave both parties frustrated at having to expend additional effort on immaterial tax liabilities.

As a result, the costs of tracking these additional benefits will likely outweigh the additional tax revenue generated, and the best approach might be to leave the extra benefits untaxed.

Transition Period

Although the proposed alternative has its merits, it also consists of multiple drawbacks which have been discussed in the preceding sections. If the proposed alternative is to be implemented, a key issue that must be addressed is the transition period. The primary question is the treatment of existing loyalty points and whether they should be classified as corporate, personal, or a mix of both. It will likely be impossible to separate existing points into corporate versus personal based upon the history of the underlying transactions since it would take tremendous effort to trace the history of each customers' points, and subsequently confirm with them whether the underlying trip was for business or personal purposes. Furthermore, the proposed alternative requires loyalty program providers to track the corporate and personal components of each customer's loyalty points which will be a lengthy exercise and may require additional capital expenditures to set up such a system. Requiring additional action from the program providers in helping to distinguish the treatment of existing customer loyalty points is placing too much of a burden on these businesses and is not encouraged.

It is also not practical to request each taxpayer who are members of loyalty programs to declare the number of points they believe should exist in each pool given that taxpayers have an incentive to place all of their existing points into the personal pool. Hence, the two options that remain are to treat all existing points as purely corporate or purely personal. Placing all existing customer loyalty points into each taxpayer's corporate pool would result in excessive taxation as the government may be taxing benefits that do not exist. This is because points may have been legitimately earned through personal expenditures, but by placing these existing points into the corporate pool would result in taxation if the points were redeemed for personal purposes. By similar reasoning, placing all existing customer loyalty points into each taxpayer's personal pool would result in under-taxation. However, it is expected that the implementation of such a proposal would lead to public dismay as many taxpayers have grown accustomed to the non-taxability of rewards obtained from customer loyalty programs. Hence, should the proposal be implemented, it is recommended that all existing customer loyalty points be treated as personal pool points to prevent additional public outrage.

Public Response

If the proposed tax system were to be implemented, the public will attempt to find ways to evade taxes by switching to other non-taxable methods. Airlines have an incentive to try to structure their reward programs to avoid creating tax liabilities for their customers in order to attract more members and gain market share from other loyalty programs. One way they can do this is to change from a frequent flyer based system into a discount based system. They could achieve this by offering repeat flyers direct discounts on future flights via vouchers or potential freebies in-flight such as discounted meals, food, and comfort options. By switching away from a points based system, they can potentially avoid tax because the proposed system specifically addresses point based systems only.

In principle however, if airlines do switch away from a points-based system into a voucher-based system, then our proposed taxation system may still apply. Airlines who do this will instead track dollar amounts for vouchers issued in their accounting systems instead of reward points. Therefore, theoretically, it would be possible to split these vouchers into a business pool and personal pool if customers are required to specify the nature of their flight (as outlined in our proposal). As a result, if airlines can effectively track vouchers and split them into business and personal, then it would also be possible for them to track, on an annual basis, how many business vouchers were redeemed for personal purposes so that they can report it to the relevant tax authorities. In theory, this would mean that our proposal can effectively tax the "rewards" in these situations as well, but will have to be reworded to ensure it encompasses these situations.

It is also important to consider that even if an airline is able to switch away from a points-based system, there may be added inconveniences to its members. For example, if the airlines switch away from a points-based system to instead offering business travellers free blankets, extra meals in flight, and better lounge access, then many members who do not value these perks will decide to switch to other rewards programs that still do offer points that can be redeemed for future flight tickets. Therefore, altering the rewards program to help members evade taxes can end up being a detriment to the airline if members decide to switch to other reward programs instead. As a result, these possible tax evasion schemes might in fact be avoided due to market pressures and customer preferences.

CONCLUSION

Although taxpayers may be relieved that the CRA has relaxed their position on the taxation of rewards from customer loyalty programs in 2009, it is important to realize that the current tax law is inequitable. The U.S., Australian, and South African taxation authorities may currently follow Canada's practice in the taxation of rewards from customer loyalty programs, but the current practice is not necessarily the best practice. Customer loyalty programs provide significant value to taxpayers every year and rewards obtained by virtue of employment clearly fall under the definition of taxable benefits in the ITA. Although the CRA's position prior to 2009 was abolished due to low compliance rates, the CRA should attempt to establish a new policy to ensure as many of the AICPA's guiding principles over tax policy are satisfied. This paper has discussed a few of the alternatives that may help ensure equity, as well as resolve some of the current concerns over valuation and monitoring. However, we have also discussed many of the drawbacks and issues associated with our proposed alternative that continue to plague the successful taxation of customer loyalty programs. Implementation of such a tax will likely result in disapproval from the general public, and the CRA must remain mindful of balancing the objectives of tax policy as well as consider the effects of the tax from the taxpayers' perspective.

APPENDICES

Appendix A – Sample of Air Miles Rewards

The purpose of this appendix is to illustrate a sample of rewards that can be redeemed through the Air Miles program and the corresponding costs (in miles) of each reward.

Category	Item	Cost (in Miles)	Retail Value ($)	Dollar Value per Mile
Electronics	Panasonic Viera 32" TV	3,600	399.99	0.1111
Electronics	Sony iPhone/iPod speaker dock	1,500	99.99	0.0667
Electronics	Nintendo 3DS XL Black Bundle	2,800	199.99	0.0714
Electronics	Google Nexus 7 Tablet Wifi 32GB	3,400	269.99	0.0794
Home & Garden	Casa Bugatti Glamour Thermal Carafe	1,400	169.99	0.1214
Home & Garden	Breville the HemisphereTM Control 750-Watt Blender	1,800	269.99	0.1500
Home & Garden	Dyson Tower Fan - White/Silver	4,000	449.99	0.1125
Home & Garden	Bosch 12V Max Lithium Ion 3/8" Drill/Driver	1,850	129.99	0.0703
Entertainment	Canada's Wonderland one day admission	375	47.99	0.1280
Entertainment	CNE Admission	100	18.00	0.1800
Luxury	Michael Kors Pippa Silver Tone Glitz Watch	2,000	140.00	0.0700
Baggage	American Tourister International Fashion 3-Piece Set - Black	1,200	135.00	0.1125
AVERAGE				**0.1061**

Appendix B - Petro-Points Reward Rates

The purpose of this appendix is to illustrate a sample of rewards that can be redeemed through Petro-Canada's loyalty program and the corresponding costs (in Petro-Points) of each reward. Petro-Points can be earned by a taxpayer by purchasing goods/services at Petro-Canada locations as follows[58]:

Item	Cost (in points	Retail Value ($)	Dollar Value per Mile
$1 Gas Reward	2,000	1.00	0.0005
Petro-Canada 2 Cycle Motor Oil*	6,000	6.99	0.0012
Fuel Saving, 5 cents/litre for 200 L	12,000	10.00	0.0008
Petro-Canada Windshield Wash*	6,000	2.99	0.0005
Basic CAA membership	60,000	69.99	0.0012
AVERAGE			**0.0008**

*Retail prices for these products were not available online. As a result, we used retail prices for an equivalent non-branded product from established retailers such as Canadian Tire, Home Depot and Amazon as a proxy.

[58] "How to Collect Petro-Points." *Petro-Canada*, n.d. Web. 8 July 2014. <http://retail.petro-canada.ca/en/petropoints/164.aspx>.

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RESPONSES TO FEEDBACK PROVIDED ON SHORT ESSAY

Akhil Agrawal and Jacky Lai, Customer Loyalty programs, B+

You have done some good research both internationally and on Canadian law. I think you understand all of the key ideas. I can understand your ideas clearly and your paper is well-organized.

The main problem with your paper is that your proposal for taxing the fringe benefit associated with frequent flyer miles is not sufficiently detailed. Here are some issues:

- The employee has the responsibility of separating travel expenditures paid to airlines into business or personal. This provides no third-party verification of the information. Contrast this with the T4 system, in which employers (who have no incentive to understate the income) report the employee's income to the CRA.
- The main difference between our proposed system and the T4 system is that airline companies have an incentive to understate the liability in order to benefit their members and retain customers. Since airline companies do not receive a deduction for the amount reported, they will be indifferent to fair value of the income inclusion reported for their customers. As a result, their main motivation to understate or overstate the liability will be to align themselves with their customers' interests to retain them as long term customers. This is a flaw that exists within our proposed system and there does not appear to be a good way to eliminate this.
- How will the cost of the ticket purchased be determined? You just assume there is a readily determined fair market value ($500 in the example). What can points in loyalty programs be used for? I think checking out a few actual customer loyalty programs would be helpful.
- We have included in our discussion the difficulties that program providers would have in determining an actual value for the rewards. We have considered both flight and non-flight rewards and discussed potential solutions and their associated drawbacks.
- If spouse #1 buys a plane ticket using spouse #2's points, who is taxable?
- We have included a discussion of this issue in the paper and concluded that the spouse who redeems the points (i.e., who owns the points) is taxable as this is consistent with the current Canadian tax law. We have also expanded supported our discussion through consideration of a breadwinner model, where the breadwinner who supports his/her family is the sole individual being taxed. The other members who share in the consumption of the income are not taxed under the current law.
- Suppose a person uses points to buy a plane ticket. The flight is overbooked, and the person accepts a $200 credit against future airfare as compensation for giving up their seat. What are the tax consequences?
- Theoretically this can be viewed in two ways. First it can be a separate contract/arrangement between the airline and the customer such that the $200 credit is compensation to the customer for accepting the inconvenience of switching to a different flight. Another approach is that it can be viewed as part of the same ticket purchase transaction and is part of the benefits received from the use of the points. Under the first approach there should be no taxable treatment because it should be treated the same way as if the customer had purchased the

flight ticket with regular money and received the credit from overbookings. Under the second, it should be taxable as it represents an increase in the fair market value of benefits received from the employer-generated business miles.

The above examples are just the beginning. There is a reason why the Income Tax Act is 2000 pages. Don't assume the world is so simple. Remember also that customer loyalty programs may be run by companies other than airlines. My brother-in-law is a traveling salesman, and frequently buys gas for work purposes and earns loyalty points. You might check the websites of gas retailers to see how these programs work and what the rewards under these programs are.

This is a good point and we have added an additional section that talks about the PetroPoints program from Petro Canada and compares it to points programs such as Air Miles.

Leandra Lederman wrote an article about third-party reporting and withholding. I think this article provides some principles on designing these systems, which you might be able to apply to your particular problem. Here is the link to her article:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1347668

This is a good point and we have evaluated our proposal against the 6 criteria required for third party reporting as proposed by Lederman.

There may also be other articles on this topic.

Are there any countries that do tax these amounts successfully? That would be most helpful. Surveying countries which have essentially given up on collecting any money is not a good way to find the successful tax collection system. Also, I believe that some of the articles you are reading contain proposals for how to tax frequent-flyer points. Do these articles contain any ideas which could improve your system?

We have expanded our analysis of the tax laws in other jurisdictions by considering the tax law in South Africa. We have also mentioned in the paper that given the time constraints, we were unable to identify any country that have been able to tax these amounts successfully. We have expanded on the analysis and the drawbacks of our proposal, and also discussed Daher's proposal in using a flat rate to tax customer loyalty points.

Your analysis of the current law is very brief. You have a discussion on page 4 of subsection 6(1), but you do not provide any court cases as to how broadly or narrowly this has been interpreted. Also, your analysis of the Mommersteeg case on page 10 does not discuss how the employee is expected to obtain the information needed to obtain the taxable amount, in that I believe the case states that the employee should use the lowest price for the class of ticket purchased.

We have expanded our discussion of the Mommersteeg case by further explaining the court's findings regarding subsection 6(1) as well as the tests the court has established in valuing the frequent flyer reward tickets.

Your discussion of the Charley case is mystifying. How is this converting frequent flyer points into money?

We have reworded the entire discussion on the Charley case so that it is clearer now and is directly applicable to our arguments. Hopefully the issue is fixed now.

On page 8, where you discuss different employee situations, you might note that many employers require that the employee use the points for business travel.

If the employee is required to use the points for future business travel then these fall into the definition of “employer controlled points”. As a result, employers who allow employees to use these points are covered by current law and are required to report a tax liability for the value of the points used. If the employer just uses them for future business travel, then it is a non-taxable event since this situation falls into discount theory as discussed in the essay.