CUMMINGS COOPER SCHUSHEIM BERLINER LLP

Barristers and Solicitors
4100 Yonge Street, Suite 408
Toronto, Ontario, M2P 2B5
Tel: 416.512.9500 Fax: 416.512.9501
www.ccsb-law.com

Avoid a border dispute: Know the tax implications of cross-border employment and assignments[1]

By: L. David Fox, Partner

In the increasingly "borderless" world in which business operates, it's common for Canadian businesses to engage individuals from other countries to perform services in Canada. It's also common for erroneous assumptions to be made about certain Canadian tax implications of these engagements by and in respect of these individuals performing services in Canada, if due consideration is given to tax at all.

Who are these individuals? They may be employees of a non-resident parent company (NRCo), who possess a particular skill set required by Canadian businesses in a particular circumstance.

Failure to understand the income tax implications can result in potential risk to the Canadian business, the NRCo and the non-resident employee. What follows is a non-exhaustive list of recommendations, considerations, tips and traps that must be taken into account in any cross-border employment or assignment arrangement.

Have policies in place

Canadian companies should have policies in place to address tax and non-tax issues surrounding non-resident employees providing services in Canada.

Central to such policies is a link between the human resources and taxation groups of such Canadian companies. While human resources groups will often facilitate non-residents entering Canada to provide services to Canadian companies, such groups may not be aware of the tax consequences associated with such arrangements, or the planning which should take place prior to the commencement of such arrangements. For this reason, consideration should be given to pro-actively preparing written policies that provide for the steps that must be taken when cross-border employment and assignments are contemplated.

Such policies need not be complex. But, once prepared, they provide an invaluable tool to companies with respect to identifying the areas that should be considered prior to, during and after any cross-border employment or assignment arrangement.

These include, among others:

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- Immigration
- Waiver applications
- Reimbursement of costs associated with cross-border employment/relocation/travel
- Benefits
- Supervision and reviews of non-resident employees while performing services in Canada
- Application of employment laws and potential for termination while in Canada
- Limitations on activities of non-resident employees in Canada
- Required income tax and other regulatory registrations
- Payroll
- Tax gross-ups
- Preparation and filing of income tax returns
- Repatriation
- Documentation preparation and retention

Canada, unlike the U.S., taxes on the basis of residency

This means that Canadian residents are subject to Canadian income tax on their worldwide incomes.

Non-residents of Canada are, generally speaking and for the purposes of this article, subject to Canadian income tax on income from employment earned in Canada. The duration of employment in Canada is not relevant to liability for income tax. A tax treaty between Canada and the jurisdiction in which the non-resident normally resides, however, may exempt the non-resident individual from Canadian income tax on earnings arising from employment in Canada. Whether such a treaty exemption applies will depend upon the facts of the relevant cross-border arrangement; it may be possible to undertake planning such that the non-resident individual may fit within an exemption in a particular tax treaty.

There is a statutory test for determining residency

With respect to the issue of residency, an (otherwise) non-resident employee may be found to be a Canadian resident even if the employee is a citizen of his/her home country.

An analysis of the residency of an employee involves the application of a statutory test in the *Income Tax Act* (Canada) and the common law (which focuses on "residential ties" to Canada and the employee's home jurisdiction). In addition, in the event that an employee

is found, under the domestic laws of both Canada and the home jurisdiction of the employee, to be resident, in both jurisdictions, residency "tie-breaker" rules in the tax treaty between Canada and the home jurisdiction of the employee (if there is such a treaty), will come into play.

If the employee is found to be a Canadian resident, the employee will then be subject to Canadian income tax on his/her worldwide income. Residency and the tests and factors related thereto should be considered prior to the employee entering Canada and throughout the time that the employee performs services in Canada. Planning may be possible to limit the risk that the employee will be viewed as a Canadian resident for income tax purposes.

Don't overlook remuneration earned but not paid prior to employment in Canada

Prior to a non-resident employee commencing duties in Canada, planning could be implemented regarding remuneration (including non-cash remuneration) earned by, but not paid to, the non-resident employee. Payment of such remuneration prior to the individual commencing duties in Canada may assist in ensuring that such remuneration is not attributable to employment services performed in Canada and, therefore, potentially not subject to Canadian income tax.

For example, bonuses awarded to the non-resident employee for services performed outside Canada for NRCo, could be paid prior to the non-resident employee commencing duties in Canada. Similarly, non-resident employees should consider whether to exercise stock options awarded by NRCo, prior to entering Canada to perform employment duties.

The CRA obligation to withhold, remit tax

With respect to non-resident employees performing duties in Canada, companies often incorrectly assume that since tax is being withheld in the non-resident employee's home jurisdiction, no income tax withholding obligation exists under the laws of Canada.

This is incorrect.

The Canadian company or NRCo (depending upon which company is paying the non-resident employee) can apply to the Canada Revenue Agency (the CRA) for a waiver of the requirement that it withhold income tax from remuneration paid to the non-resident employee and remit the tax withheld to the CRA. However, applicants for waivers should bear in mind that such waiver applications involved an analysis by the CRA of all of the circumstances surrounding the non-resident employee's performance of services in Canada (e.g., the contract under which the non-resident employee is required to perform services in Canada, proof of residency status of the non-resident employee, past compliance by the Canadian company or NRCo in respect of the withholding, remitting and reporting obligations in respect of non-resident employees performing services in Canada, etc.). As such, the waiver system can be somewhat cumbersome and administratively burdensome for Canadian company, NRCO and/or the non-resident employee.

Budget 2015 attempts to address this issue by proposing an exception to the above-mentioned withholding requirement if the employer and employee meet the newly proposed criteria to qualify, respectively, as a "qualifying non-resident employer" and a "qualifying non-resident employee," in respect of a payment for employment services performed in Canada. As proposed by Budget 2015, an employer will be a "qualifying non-resident employer" in the following circumstances:

a) the employer (other than a partnership) must be resident in a country with which Canada has a tax treaty;

b) if the employer is a partnership, at least 90% of the partnership's income for the fiscal period that includes the time of payment must be allocated to persons that are residents in a treaty country;

c) in either of the above scenarios, the employer must not carry on business through a Canadian permanent establishment (what constitutes a "permanent establishment" is determined in accordance with the terms of the relevant tax treaty between the country in which the non-resident employer is resident and Canada) of the employer in its fiscal period that includes the time of the payments and the employer must be certified by the Minister of National Revenue at the time of the payment. In order to become "certified," the non-resident employer must apply to the Minister of National Revenue using a prescribed form. Such "certification" is proposed to only be provided for a specified period of time (i.e., a non-resident corporation once certified is not forever certified) and may be revoked.

Budget 2015 proposes that an employee will be a "qualifying non-resident employee" in respect of a payment if the employee:

a) is, at that time, resident in a country with which Canada has a tax treaty;

b) is not liable to tax under Part I of the *Income Tax Act* (Canada) in respect of the payment because of that treaty; and

c) is not present in Canada for 90 or more days in any 12-month period that includes the time of payment.

While this proposed measure will be welcomed by the business community, the measure does not completely eliminate NRCo's responsibility, or potential liability, with respect to payments to non-resident employees for employment exercised in Canada, even if NRCo is a "qualifying non-resident employer". Budget 2015 states that a "qualifying non-resident employer" must still fulfill its reporting requirements under the *Income Tax Act* (Canada) with respect to amounts paid to non-resident employees for employment services rendered in Canada and that NRCo will continue to be liable for any amounts required to be withheld and remitted to the CRA in respect of payments to non-resident employees who are not "qualifying non-resident employees". However, Budget 2015 also proposes a due diligence-type defence for employers in that a "qualifying non-resident employer" will not be liable for penalties under the ITA for failing to withhold and remit income tax from

payments to non-resident employees for employment exercised in Canada if, after reasonable inquiry, the employer had no reason to believe, at the time of payment, that the employee did not meet the conditions to be a "qualifying non-resident employee".

It is questionable how helpful this proposed amendment will be in the frequent circumstance that decisions to send non-resident employees to Canada are made mere days or weeks before the employees are to come to Canada. In such circumstances, one speculates that it is unlikely that NRCo would be able to become certified by the Minister of National Revenue such that the proposed amendments, if they would otherwise apply, will be relevant.

At this time, this measure remains only a proposed amendment to the *Income Tax Act* (Canada) and, if enacted, will apply in respect of payments made after 2015.

In the absence of such a waiver, or meeting the requirements of the above mentioned proposed amendments to the *Income Tax Act* (Canada) once enacted, the Canadian resident company or NRCo must withhold income tax from remuneration paid to the non-resident employee performing services in Canada and remit the tax withheld to the CRA.

This obligation applies regardless of withholding that may be required in the employee's home jurisdiction. The possibility of double withholding does, therefore, exist. The employee may, ultimately and depending upon the facts of the scenario, be entitled to a refund of any such Canadian tax withheld. If so entitled, however, the employee will be required to file a Canadian income tax return to obtain a refund.

Assuming the employee remains a non-resident of Canada for income tax purposes, failing to withhold and remit to the CRA income taxes as required may result in an assessment by the CRA of the Canadian resident company or NRCo (depending upon which entity is paying the employee) for the taxes which should have been withheld, plus penalties and non-deductible, compound interest.

Don't forget about CPP and EI obligations

With respect to non-resident employees performing services in Canada, withholding, paying and remitting obligations may also exist with respect to Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums.

Certain exemptions from the withholding and remitting requirements in respect of CPP and EI do exist where, for example, comparable amounts are being withheld and remitted in the employee's home country. But companies must not make assumptions that such exemptions will apply. Failing to withhold and remit CPP contributions and EI premiums when required to do so may result in the payor being assessed for both the employer and employee portions of CPP and EI, as well as penalties and non-deductible, compound interest. Provincial taxes must also be considered, such as Ontario's Employer Health Tax.

The payor is responsible for the T4

The entity paying the non-resident employee must prepare a T4 information return reporting the remuneration and payroll taxes withheld and file such return with the CRA. The T4 information return must also be issued to the non-resident employee. Penalties may be imposed for failing to prepare, issue and file T4 information returns when required to do so.

Is the NRCo carrying on business in Canada by default?

If the non-resident employee is an employee of NRCo while performing duties in Canada, NRCo may be found to be carrying on business in Canada by virtue of the activities of the employee in Canada. Subject to a treaty exemption, if NRCo is carrying on business in Canada, it is subject to income tax on its Canadian business income. Regardless of a treaty, NRCo will be required to file a Canadian income tax return. Also, regardless of any treaty exemption, NRCo will likely be required to become registered for Canada's federal value-added tax (GST/HST), which will have major ramifications on how the NRCo business accounts for tax in Canada.

The question of a 'permanent establishment'

If a tax treaty applies, NRCo will not be liable to Canadian income tax if it does not carry on business in Canada through a "permanent establishment." The presence and activities of the non-resident employee in Canada, and the activities of NRCo in Canada, may create a permanent establishment for NRCo in Canada and a liability for tax. Planning in an effort to minimize the risk that NRCo could be found to have a permanent establishment in Canada should be considered, prior to the non-resident employee commencing work in Canada. Even if no permanent establishment exists, as noted above, if NRCo is carrying on business in Canada, the company will be required to file a treaty-based income tax return with the CRA. Penalties and interest may apply for failing to file a Canadian income tax return when required to do so.

The 15 per cent withholding tax obligation

Reimbursement by a Canadian company to its parent, NRCo, for the cost of the non-resident employee's remuneration for services rendered in Canada will, in the absence of a waiver, give rise to an obligation on the Canadian company to withhold and remit 15 per cent of the reimbursement to the CRA. If the Canadian entity fails to withhold and remit as required, it can be held liable for the 15 per cent tax, plus penalties and non-deductible, compound interest.

A possible refund of that 15 per cent

Depending on the facts, NRCo may be eligible for a refund of this 15 per cent withholding tax. But NRCo will be required to file a Canadian income tax return to claim the refund and there are time limits for doing so.

There are ways to minimize an NRCo's tax risks

Planning may be undertaken to minimize the Canadian income tax risks to NRCo and the non-resident employee. For example, consideration may be given to a written secondment agreement, incorporation of a Canadian subsidiary or a formal transfer of the relevant non-resident employee to the Canadian company.

What about hiring a non-resident, independent contractor?

Companies may hire non-resident contractors who have specialized skills or expertise to perform services in Canada.

Assuming that the non-resident contractors are, in fact, independent contractors and not employees of the relevant companies, the withholding, remitting and reporting requirements applicable to remuneration paid to employees performing services in Canada will not apply.

However, many companies are unaware of the requirement under the *Income Tax Act* (Canada) that they withhold 15 per cent of all fees, commissions or other amounts paid to a non-resident of Canada in respect of services performed by that non-resident in Canada.

The amounts so withheld must be remitted to the CRA within certain prescribed timelines, and the company paying the non-resident contractor in respect of services rendered in Canada must prepare a T4A-NR information return reporting the fees, commissions or other amounts paid to the non-resident contractor and the tax withheld and remitted. The T4A-NR information return must be filed by the payor with the CRA and must also be issued to the non-resident contractor.

If the company paying the non-resident contractor fails to withhold and remit the 15 per cent tax as required, the CRA can assess the company for the tax, along with penalties and non-deductible, compound interest.

The non-resident contractor may apply to the CRA for a waiver of this withholding requirement. Any such waiver application should be made as soon as possible following the non-resident contractor contracting to perform services in Canada, since such waiver applications necessitate the submission to the CRA of a significant amount of information and documentation, which the CRA will review prior to determining whether to grant a waiver. Absent such a waiver, the company paying fees, commissions or other amounts to the non-resident contractor is required to withhold and remit the 15 per cent tax.

It is important to note that the residency of the payor is not relevant for the purposes of the 15 per cent withholding requirement. That is, even if a non-resident company pays another non-resident contractor for services rendered in Canada, the non-resident company is required to withhold and remit the 15 per cent tax and prepare, issue and file the T4A-NR information return.

If a mistake has already been made, avoid trouble with a voluntary disclosure

Where non-resident or Canadian businesses have made errors or omissions with respect to their withholding, remitting and reporting requirements (be it in the context of a non-

resident employee or non-resident contractor performing services in Canada) consideration may be given to submitting a voluntary disclosure to the CRA.

This can, in certain circumstances, reduce the potential for an assessment by the CRA of penalties in respect of such errors and omissions, provide some relief from interest, and avoid the possibility of criminal prosecution for violating the *Income Tax Act* (Canada) or another tax statute.

L. David Fox is a Partner in the Corporation and Personal Income Tax Planning group at Cummings Cooper Schusheim Berliner LLP. He can be reached at dfox@ccsb-law.com, or at 416 733 5264.