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CROSS-BORDER EMPLOYMENT

Amendments to Article XV of the Canada–U.S. Tax Convention: an Update

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In an increasingly global economy, it is relatively commonplace for residents of the United States to provide employment services, whether on a transitory or a substantial basis, in Canada. In such situations, an analysis of Article XV of the *Canada–United States Tax Convention* (the "Treaty") is critical, as it may provide relief from Canadian taxation on the employment income earned by the U.S. resident (and also in the reverse situation where a Canadian resident provides employment services in the U.S.). As canvassed in earlier articles published in this journal,[1] the Fifth Protocol (the "Protocol") to the Treaty, signed on September 21, 2007, has significant implications on cross-border employment and, in particular, amends Article XV significantly. Nearly a year after it was first released, the United States Senate ratified the Protocol on September 23, 2008[2] and the Protocol will enter into force once Canada and the U.S. exchange instruments of ratification, anticipated to occur prior to the end of 2008. With the implementation of the Protocol fast-approaching, this article discusses the Protocol amendments made to Article XV of the Treaty,[3] now entitled "Income from Employment," and reviews certain of the interpretational issues and limited guidance thereon now available from the U.S. Department of Treasury Technical Explanation, which is generally viewed as a document representing the mutual views of Canada and the U.S. on the Protocol's contents.[4]

Application of Article XV

The pre-Protocol version of Article XV(1) applies to "salaries, wages, and other similar remuneration" derived by a resident of one country in respect of employment exercised in the other country. This phraseology is not defined in either the Treaty or in the Income Tax Act[5] and had led to interpretational issues as to the scope, in particular, of the phrase "similar remuneration." For example, in *Hale v. The Queen*,[6] the Federal Court interpreted identical wording in the *Canada–United Kingdom Tax Convention*as meaning a sum of money received in return for the provision of services and, as such, held that it did not refer to benefits from employment pursuant to section 7 of the Act. Under the Protocol amendments, the word "similar" has been deleted. According to the Technical Explanation, this change is intended to ensure that Article XV applies to all remuneration (including payments in-kind) derived in connection with employment. Notwithstanding *Hale*and other decisions, it is not anticipated that this will result in any significant difference in how Article XV is normally applied as the change is consistent with

the typical approach of the Canada Revenue Agency (the "CRA").

Article XV(2) – Exemptions From Canadian Tax

The real substance of the Protocol amendments in the cross-border employment context are to Article XV (2), which provides for a two-pronged exemption from Canadian tax for employment income earned by a U.S. resident who performs employment services in Canada. Under the pre-Protocol version of this provision, the exemption from Canadian tax was available where:

- the remuneration did not exceed Cdn$10,000 in the relevant calendar year; or

- the U.S. resident was present in Canada for 183 days or less in a particular calendar year and the remuneration was not borne by an employer resident in Canada or a Canadian permanent establishment ("PE") of the employer. The term "borne by" in this context is interpreted to mean "allowable as a deduction in computing taxable income."

The Protocol amends the requirements of these exemptions from Canadian tax in the following material ways:

- the reference to a "calendar year" is deleted from both prongs of the test and replaced with a 12-month period in the second exemption; and

- the second prong of the test is also amended to require that the remuneration not be paid by or on behalf of a Canadian resident or be borne by a Canadian PE.

While the reference to a calendar year is deleted in both prongs of the exception, the Technical Explanation clarifies that the $10,000 limit is still to be determined on a calendar-year basis, such that the change to the period of measurement applies only to the second prong of the test. The impact of this change is that the 183-day period is now to be measured in any 12-month period commencing or ending in the particular year. As a consequence, Canadian source taxation can no longer be avoided simply by arranging employment services to straddle two taxation years. The significant practical issue arising from this change is that, in a given tax year, it may not be determinable whether or not the U.S. resident will ultimately be subject to Canadian tax, making tax filings and refund applications (potentially for source withholdings) particularly cumbersome.

A perhaps more fundamental amendment is the deletion of the term "employer" in the second part of the 183-day test. The new provision requires that the remuneration not be paid by, or on behalf of, a Canadian resident and not be borne by a Canadian PE. The change raises separate, but inter-related, concerns.

The first is whether the exemption from Canadian tax will be available where a U.S. resident is employed by a U.S. corporation but provides services for the Canadian PE and the U.S. corporation charges the PE for the services. In that situation, the Technical Explanation confirms that the exemption from Canadian tax will not be available, on the basis that the remuneration is borne by a Canadian PE. A similar scenario, which is not discussed in the Technical Explanation, is one where services are provided to a Canadian subsidiary and the subsidiary bears the cost of the remuneration paid through a cross-charge by a U.S. affiliate. In such a situation, could it be said that the remuneration is being "paid on behalf of" the Canadian subsidiary?

A second concern arose from the fact the amended wording of Article XV(2) no longer explicitly requires an "employer" or even an "employment relationship," as it refers only to remuneration paid by a "person"

resident in one of the countries. The Technical Explanation attempts to clarify this by providing that the change was intended only to respond to abusive cases where the form of the relationship did not match its substance as being one of employment. As explained in the Report by the U.S. Joint Committee on Taxation on the Protocol (the "JCT Report"), which was released prior to the Technical Explanation, the abuse which was in the minds of the drafters was one in which an intermediary employer (for example, an international hiring company) with little substantive involvement in the services being performed is interposed to avoid direct remuneration by a person resident in a treaty country. In such a situation, the OECD commentary on the model treaty provides that an analysis should be done as to who the "true" employer is. It will be of interest to practitioners and to cross-border employees whether the amendment will indeed be interpreted by the CRA and the IRS in this limited manner.

The requirement that the remuneration not be borne by a Canadian PE must also be read in the context of the amendments to Article V of the Treaty, which will, once the Protocol comes into force, deem a Canadian PE to exist where a U.S. corporation has employees present in Canada for 183 days or more in any 12-month period and certain other conditions are met. It follows that no employee of such deemed PE would be entitled to the exemption from Canadian source taxation, even if the individual employee is himself or herself present in Canada for less than 183 days in the requisite 12-month period. The JCT Report acknowledges the burden that a deemed PE causes and encourages the competent authorities to adopt rules to reduce the potential for excess withholding taxes, but does not provide any guidance on what types of administrative relief may be forthcoming. The reference to withholding taxes is also interesting, given the long-standing position of the CRA that, even where a non-resident employee is entitled to relief pursuant to the provisions of a tax treaty between Canada and his or her jurisdiction of residence, absent a waiver, the requirement to withhold tax on Canadian-source employment income will nevertheless apply to the employer entity. It will be interesting to see if the CRA will grant waivers from withholdings in situations where it is not clear, at the time of the application, whether the employer will have a deemed PE in Canada.

Stock Options

The diplomatic notes exchanged in connection with the Protocol also set forth new concepts regarding the taxation of stock options, providing a per diem approach to allocation, based on the number of days in which the individual's "principal place of employment" was in Canada or the United States during the period extending from the date the option was granted and the date the option is exercised. This approach gives rise to many interpretational issues, including the meaning of principal place of employment and the impact of some employment being exercised in a third country during the relevant period. Although the JCT Report acknowledges that this treatment of stock options differs from both the U.S. and OECD model treaties, no further clarification is provided.

Conclusion

While the Technical Explanation provides some guidance on the meaning of the Protocol amendments to Article XV of the Treaty, many questions remain unanswered and it will be up to the employers and individuals involved to ensure that exemptions from Canadian tax are not inadvertently lost.

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[1] See, for example, Peter Megoudis, "The Impact of the New Canada-United States Treaty Protocol on Cross-border Executives" (March 2007) 18 *Taxation of Executive Compensation and Retirement* 795 and Anu Nijhawan, "Protocol to the Canada-U.S. Tax Treaty: Implications for Cross-border Employment" (June 2007) 18 *Taxation of Executive Compensation and Retirement* 853.

[2]Canada previously ratified the Protocol on December 14, 2007, when Bill S-2 received Royal Assent.

[3]Amendments to other Articles of the Treaty may also impact cross-border employment, but such other Articles are not discussed herein.

[4] The Technical Explanation was released on July 10, 2008. While it is a U.S. document, the Department of Finance has indicated that "it accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of various provisions in the Protocol." See News Release 2008-052 (July 10, 2008). It is to be noted, however, that the authority offered by the Technical Explanation is not entirely clear. In *Coblentz v. R.*, [1996] 3 CTC 295 (F.C.A.),the Court acknowledged that the Technical Explanation could be used for the purposes of interpretation, but in *Kubicek Estate v. R.*, [1997] 3 CTC 435 (F.C.A.), the Court stated that, while of interest to a court, the Technical Explanation would not necessarily be decisive of the issue.

[5] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[6] 90 DTC 6481 (F.C.T.D.).

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