Practice Notes and Comments

This regular feature is edited by Gregory J. Winfield of McCarthy Tétrault LLP. It discusses tax developments affecting the taxation of compensation and retirement and focuses on Canada Revenue Agency policies and practices.

SOURCE WITHHOLDINGS

Source Withholdings for U.S. Employees in Canada: an Ongoing Challenge

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Introduction

It is often surprising for United States or other foreign-based corporations to discover that payments made to non-residents of Canada who perform employment services in Canada are, absent a waiver from the Canada Revenue Agency (the "CRA"), subject to Canadian tax withholding, even if such income is ultimately exempt from Canadian income tax under a tax treaty. Recent changes announced in the Canadian federal budget assist, by adding, effective January 1, 2016, an exemption to the withholding requirement where: (i) the employer is a non-resident of Canada, is resident in a country with which Canada has a tax treaty, and does not carry on business in Canada through a permanent establishment; (ii) the employee is exempt from Canadian tax under a tax treaty; and (iii) the employee is present in Canada for less than 90 days in any 12-month period that includes the time of payment.[1] Employers will, however, remain liable for any withholdings in respect of non-resident employees where these conditions are not satisfied. This article[2] revisits the applicable withholding obligations where the new exemption does not apply, with a view to providing guidance on the appropriate actions of a non-resident employer in this type of situation in order to comply with its withholding obligations[3] without needlessly putting undue hardship on its non-resident employees who are in Canada on only an occasional basis. The focus herein is on U.S. resident employees, although similar concerns apply to residents of other jurisdictions.

Canadian Tax Liability of Non-resident Employee Performing Duties in Canada

Non-residents are subject to tax under Part I of the Income Tax Act[4] on all income from "office and employment" that is attributable to duties performed in Canada. Accordingly, absent relief under the applicable provisions of a reciprocal tax treaty, where a non-Canadian resident performs any amount of employment duties in Canada, even, for example, the mere attendance in Canada for a one-day meeting, he or she will be subject to Canadian income tax on the portion of the income attributable to Canadian duties.

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[1] The foreign employer must be certified by the Minister in order for this exemption to be available.

[2] This article provides an update of the issues considered more than ten years ago: see Anu Nijhawan, "Source Withholdings: Non-resident Employees 'Visiting' Canada" (May 2004) 15 *Taxation of Executive Compensation and Retirement* 412.

[3] This article does not consider source withholdings in respect of Canada Pension Plan contributions and Employment Insurance premiums. For guidance on these issues, reference should be made to the provisions of the *Canada Pension Plan Act* and to the *Employment Insurance Act*, as well as to the reciprocal social security treaties that Canada has entered into with various foreign jurisdictions. See, for example, the 1981 Canada-U.S. Agreement with Respect to Social Security and the 1942 Canada-U.S. Agreement Respecting Unemployment Insurance. Relief from CPP withholdings may be available where the employee obtains a certificate of social security coverage in his or her country of residence. Relief from EI premiums is generally available where premiums are required to be paid in the employee's country of residence on the employment income from providing services in Canada.

[4] 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.

Depending on where a non-resident individual employee is resident, relief from the foregoing Canadian income tax may be available pursuant to the provisions of a reciprocal tax treaty. For example, in the case of a U.S. resident, Article XV(2) of the *Canada-U.S. Tax Convention* generally provides that a resident of the United States is not subject to Canadian tax in respect of Canadian employment income where:

- such remuneration does not exceed Cdn$10,000 in a calendar year; or
- the individual is not present in Canada in excess of 183 days in any 12-month period beginning or ending in the tax year and the remuneration is not paid by or on behalf of a Canadian-resident person and is not borne by a Canadian permanent establishment. The CRA has confirmed that the second branch of this test is met even where the costs of a U.S. employee are cross-charged to a Canadian subsidiary, so long as there is no employment relationship, in substance or form, between the Canadian corporation and the individual.[5]

Accordingly, in the circumstances with which this article is concerned, where the provisions of a tax treaty apply, a U.S. individual who is present in Canada only on a transitory basis and whose salary is borne entirely by his or her foreign employer should not be subject to Canadian income tax. This conclusion does not, however, end the analysis.

Obligation to Make Source Withholdings

The Act requires "every person" paying salaries and wages or other remuneration to make and remit to the CRA source withholdings in respect of Canadian tax from any such payments.[6] Because this obligation applies to "every person," the withholding obligation applies equally to Canadian resident employers and to non-resident employers. Failure to make the prescribed source withholdings may subject the non-resident employer to liability for the whole of the amount that should have been withheld (subject to a statutory right to recover the amounts from the non-resident employee) plus interest and penalties.

Even when the treaty exemptions from Canadian income tax are available, the CRA has long adopted the position that the requirement to make source withholdings nevertheless applies,[7] subject to the new exemption introduced by the Canadian federal budget. This position, while seemingly harsh, is, in the writer's view, technically correct, at least under Article XV of the Canada-U.S. Treaty, since the article applies only to an individual's substantive Canadian tax liability; it does not refer to the payer's Canadian employment withholding, remittance, or reporting responsibilities.[8]

The necessity for an employer to make Canadian source withholdings in respect of amounts paid to a non-resident employee may lead to undue hardship for such employees, particularly where the jurisdiction of the employee's residence also mandates source withholdings in respect of Canadian-source employment income. For example, where a U.S.-resident employee provides services for a U.S. corporation in both the U.S. and Canada, it is generally understood that the remuneration in respect of Canadian services will be subject to both Canadian and U.S. source withholdings. If a treaty exemption is available, the Canadian withholdings should ultimately be recoverable by the U.S. employee filing a Canadian tax return but the employee will nonetheless be out-of-pocket for excess tax until such time as the Canadian tax refund is received. In such a situation, a waiver should be considered.

Application for a Waiver

The CRA has adopted two waiver application forms to be used where relief from

[5] See, for example, CRA *Document* 2011-0418281E5 (January 23, 2012).

[6] Pursuant to Regulation 102, such withholding is to be made on a graduated basis, depending on the amount of the payment.

[7] The CRA has adopted an administrative exemption for U.S. employees attending a conference in Canada for 10 days or less and earning less than Cdn$10,000: CRA *Document* 2012-0440741I7 (July 6, 2012).

[8] This should be contrasted, for example, with article 15(5) of the *Canada-United Kingdom Tax Convention*, which provides for relief from double withholding obligations when both countries impose withholding on the same income. In such a case, the country in which the employment income is derived is permitted to make withholdings, but the other country is not.

withholding is requested due to a tax treaty exemption.

The first, Form R102-J (Regulation 102 Treaty Based Waiver Application – Joint Employer/Employee), is to be used where the U.S. resident will earn no more than Cdn$10,000 or where it is not practical to apply for the second type of waiver before the start of the services because of the nature of the services being performed (for example, services for which the dates and names of employees coming to Canada cannot be determined until the last minute).

The most recent release of this form indicates that it should be submitted 30 days before the commencement of services in Canada, but it is understood that the CRA has adopted a more flexible position. If a waiver application is approved, the CRA will issue a letter to the employee and the employer authorizing the employer not to withhold tax on payments made to the employee. The authorization is effective on the later of the start date for the services provided by the employee in Canada that year and 60 days before the date that the CRA received the complete waiver application. This method allows an employer to receive a waiver that has an effective date preceding the waiver application date.

If the R-102J waiver is not available, the second form, Form R102-R (Regulation 102 Waiver Application) is to be used. In order to apply for an R102-R waiver, the employee must have a SIN (required and available only if the employee has a legal right to work in Canada) or an ITN. This form of application also requires a written attestation for the employer concerning the applicability of a tax treaty exemption.

Even where a waiver is granted or the new withholding exemption applies, the employer will still be required to issue T4 information slips to the non-resident employee and the non-resident employee will still be required to file a Canadian income tax return if he or she has a Canadian tax liability for the year.

Impact of Perimeter Initiative

We suspect that, historically, many U.S. and other non-resident corporations have taken the practical position that, where the physical presence in Canada of their employees is infrequent and transitory and most communications and work product originate from the U.S. office, all of the employment services are in substance rendered outside Canada such that there is no withholding required.[9] This argument, is, however, difficult to make where a non-resident employee is physically present in Canada during the course of his or her employment and receives a specific amount that can be shown to be related to his or her presence in Canada.

The relatively new joint initiative[10] between Canada and the United States to share information about when individuals cross the Canada-U.S. border allows both countries to accurately track the number of days spent in each country by a particular individual. Although not as tax imitative *per se*, the collected information is expected to highlight the withholding issue. With this governmental tracking system in place, it is important that non-resident individuals and employees take steps to comply with their Canadian withholding tax obligations.

[9] Regulation 104(2) contains an exemption from withholding where the employee is neither employed in nor resident in Canada at the time of the payment and the remuneration is not attributable to employment duties performed in Canada.

[10] See "Beyond the Border: A Shared Vision for Perimeter Security and Economic Competitiveness." The section entitled "Entry/Exit Initiative of the Perimeter Security and Economic Competitiveness Action Plan" became fully effective on June 30, 2014.