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Incentives and Benefits

This regular feature is edited by Julie Y. Lee, of Osler, Hoskin & Harcourt LLP. It examines major trends and tax planning issues pertaining to executive incentive and benefit plans and arrangements.

CANADA-U.S. TREATY

Protocol to the Canada-U.S. Tax Treaty: Implications for Cross-border Employment

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The Fifth Protocol (the "Protocol") to the *Canada–United States Tax Convention*(the "Treaty"),[1] signed on September 21, 2007, has far-reaching implications, including for individuals who are resident in one jurisdiction but provide employment services in the other. In the cross-border employment context, two amendments are particularly noteworthy – the amendments to Article XV dealing with the so-called "183-day rule" for exemptions from source-country taxation and the introduction of new rules for the apportionment of stock options. Both amendments will come into force when the Protocol comes into force. While the full impact of these rules remains to be seen, this article outlines some of the potential ramifications.

Article XV(2)(b): the 183-Day Rule

Under current Article XV(2)(b), an individual who is a resident of the United States but who performs employment services in Canada, is exempt from Canadian source taxation on such employment income to the extent that he or she is present in Canada for no more than 183 days in a particular calendar year and his or her remuneration is not bourne by:[2] (i) an employer who is a resident of Canada; or (ii) by a permanent establishment ("PE") of the employer in Canada.[3] Thus, so long as a U.S. resident's employer was not a resident of Canada and did not have a PE in Canada, the employee could, for example, spend 200 days in Canada over two years but would not be subject to Canadian taxation so long as he or she spent less than 184 days in Canada in any particular calendar year. The Protocol amends this rule in two significant respects.

Under the Protocol, to avoid Canadian source taxation, the U.S. resident must be present in Canada for

no more than 183 days in any 12-month period commencing or ending in the relevant taxation year concerned. Thus, once the Protocol comes into effect, because the 183-day period will no longer need to be measured in any specific calendar year, Canadian source taxation can no longer be avoided simply by arranging employment services to straddle two taxation years and the employee in the example above would be subject to Canadian taxation. This amendment significantly expands the scope of Canadian taxation and individuals (and their employers) who frequently participate in cross-border travel will need to more closely monitor the number of days spent in Canada. Notably, the Canada Revenue Agency ("CRA") takes the position that each travel day into and out of Canada will generally count towards the 183-day limit.

The Protocol also amends the second prong of the 183-day test in Article XV(2)(b). Namely, even where the day limit is not exceeded, employment income earned by a U.S. resident in Canada will only be exempt from Canadian source taxation if the remuneration is not paid "by, or on behalf of," a Canadian resident and is not bourne by a Canadian permanent establishment. This change has at least two further broadening effects.

First, under the current version of Article XV(2)(b), the remuneration could not be bourne by an "employer" that was a Canadian resident. Thus, it was arguable that even where a Canadian resident bore the expense by virtue of being charged a management fee from its U.S. affiliate, the exemption from Canadian tax was available on the basis that the Canadian resident was not the "employer." Under the Protocol, however, the reference to "employer" has been deleted, meaning that, where remuneration is bourne by any Canadian resident, including perhaps through a cross-charge by a U.S. affiliate, the exemption from Canadian taxation will be lost. Taken to the extreme, given that transfer pricing principles will generally require cross-charges between affiliates where employees of one corporation provide services to another, it may be that the exemption from Canadian source taxation will, in effect, be rarely available where an individual employed by a U.S. corporation travels to Canada to provide services for a related Canadian corporation.

Second, the amendments to Article XV(2)(b) must be read in conjunction with the amendments made by the Protocol to the PE rules in Article V. The Protocol amends Article V so that, in some circumstances, a U.S. corporation could be seen to have a PE in Canada by virtue of having an individual employee present in Canada for 183 days or more in any 12-month period. Where that deeming rule applies, the U.S. employer will be seen to have a PE is Canada. It would then follow 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.

Allocation of Stock Option Benefit

In addition to the Protocol itself, paragraph 6 of the diplomatic notes forming Annex B contains a basis for apportioning taxing rights between Canada and the United States where an employee is granted stock options while employed in one country but the employee is resident in the other country at the time the option is exercised or disposed of.[4] The apportionment rules apply where an individual is granted an option to acquire shares or units ("securities") of the employer or of any "related entity."

The issue of the appropriate apportionment of stock option benefits has historically arisen in many scenarios. For example, where an individual is granted a stock option at a time he or she is employed in Canada and then moves to the United States prior to the exercise of the option, the question arises as to which jurisdiction should have the first right to tax.[5] This scenario arose in *Hurd v. The Queen*,[6] wherein the Federal Court of Appeal held that the non-resident optionholder was subject to taxation in Canada, pursuant to paragraph 7(1)(*a*) of the Income Tax Act,[7] in the year of exercise. The issue of apportionment can also arise where, for example, a U.S.-resident individual is granted options while

employed in the U.S. but then immigrates to Canada prior to the exercise of the option.[8] This scenario arose in *Tedmon v. MNR*,[9] wherein the Tax Court held that the taxpayer should be taxed pursuant to paragraph 7(1)(*a*) even though the options were not related in any way to his employment in Canada. The appropriate application of the Treaty, and in particular of Article XV, in either circumstance has been the subject of debate and the CRA has recognized the possibility of double taxation in scenarios where both Canada and the United States assert their right to tax, suggesting that competent authority relief should be sought.[10]

The result in some, but not all, of these situations is dealt with in the diplomatic notes. In particular, the Protocol provides for an allocation formula based on a *per diem* approach. Under the approach, Canada is permitted to tax the proportion of the stock option benefit as determined by the following formula:

> The # of days in which the individual's "principal place of employment" for the employer was in Canada during the period extending from the date the option was granted to the date the option was exercised or disposed of
>
> divided by
>
> The total # of days in the same period which the individual was employed by the employer.

The foregoing formula indicates a view that the stock option benefit is to be apportioned over each day between the date of an option grant and the date of option exercise and, to that extent, represents a shift from the CRA's administrative position that, in the absence of compelling evidence to the contrary, the entire benefit realized on the grant of a stock option is attributable to employment in the year of grant. [11]

The diplomatic notes also permit the competent authorities of each of Canada and the United States to attribute the stock option benefit differently where they agree that "the terms of the option were such that the grant of the option will be appropriately treated as transfer of ownership of securities," giving the example of situations where the options are in-the-money or were not subject to a substantial vesting period. This appears to acknowledge the possibility that a stock option could be considered to relate to past services (i.e., services rendered prior to grant) where the option has value at the date of grant or is immediately exercisable. It would appear, however, that the *per diem* allocation approach must be followed unless and until the competent authorities otherwise agree. It remains to be seen when resort to the competent authorities will be necessary, and who is to initiate the process – i.e., the individual employee or one of the competent authorities.

Notwithstanding the welcome clarification offered by the Protocol, significant uncertainty remains. For example, contrary to the recommendation of the OECD that stock option benefits be apportioned based on where employment is "exercised," the Protocol uses the concept of "principal place of employment" but does not define the term. Given the generally accepted meaning of "principal" as being 50% or more, this raises several possibilities. For example, is the principal place of employment where the employee performs services more than 50% of the time, the location where the employee reports for work more than 50% of the time, or the location from which the employee receives direction from the employer more than 50% of time. Further, it is unclear whether the 50% test should be applied over a particular fiscal period or on a day-to-day basis. For example, is it possible for an employee to have a principal place of employment in Canada at the beginning of the week and then a principal place of employment in the U.S. at the end of the week, depending on where he or she reports for work?

Further, the allocation formula only applies where the option is to acquire securities of an employer or of a "related entity." The term "related" is not defined in the Protocol. Notably, section 7 applies to options

granted to acquire securities of an employer or a non-arm's length entity. Given that the concept of "non-arm's length" is broader than that of "related," at least for purposes of the Act, it would seem that there may be situations where section 7 may apply and the stock option allocation rules in the Protocol would not.

It is also interesting to note that the allocation formula does not take into account a vesting date of the option. This is contrary to the recent recommendations of the OECD that a stock option benefit should not be considered to relate to services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise the stock option – i.e., the stock option benefit should relate to the period of time between the date of grant and the date of vesting, where continued employment is a condition of vesting. The omission of this type of vesting concept would appear to permit, in theory, an employee to allocate more or less of the stock option benefit to one jurisdiction by continuing to hold a vested option and timing the date of exercise so as to give rise to the best tax result.

In addition, there are numerous situations in which the allocation formula provided by the Protocol would not appear to apply. For example, query the appropriate apportionment if the option grant was in respect of service by the employee in both Canada and the U.S. or where the employee has a principal place of employment in a third country between date of grant and date of exercise. Further, the allocation rules do not address the situation where an employee changes jurisdictions between the date an option is granted and the date of exercise but where the employment with the same employer does not continue.

Conclusion

It is clear that the Protocol will have a significant impact on individuals who perform employment services in both Canada and the U.S. or in the jurisdiction of which they are not resident. While the potential for Canadian taxation in the cross-border employment context has been broadened, significant interpretative issues remain.

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[1] Unless otherwise noted, all references to Articles are references to the appropriate Article of the Treaty.

[2] "Bourne by" generally means allowable as a deduction in computing income, as per the 1984 Technical Explanation.

[3] This exemption from tax is in addition to the exemption in Article XV(2)(a), which applies where the employment income earned in Canada by a U.S. resident does not exceed $10,000 in the particular calendar year. As amended by the Protocol, no specific time frame is contemplated for the $10,000 limit, as it is unclear whether such limit will continue to apply per calendar year or will now apply over a rolling 12-month period.

[4] While the diplomatic notes do not form part of the Treaty *per se*, Canadian jurisprudence generally recognizes that diplomatic notes should be given great weight in interpreting treaty provisions, unless a contrary intention can be shown. See, for example, *Edwards v. R.*, 2003 FCA 387.

[5] Notably, by reason of paragraph (*c*) of the definition of "excluded right or interest" in subsection 128.1(10), stock options are not subject to deemed disposition at the time of emigration.

[6] 81 DTC 5140 (FCA). See, also, *Hale v. The Queen*, 90 DTC 6481 (FCTD), aff'd 92 DTC 6473

(FCA).

[7] 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.

[8] As was the case with emigration, immigration does not automatically result in a deemed disposition of the option.

[9] 91 DTC 962 (TCC).

[10] See, for example, CRA *Document* 2003-003727117 (February 6, 2004).

[11]Ibid.

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