Non-Resident Employee Withholding Rules

The presence of foreign employees on the payroll is a fact of life for many if not most Canadian companies. Although globalism is exciting, it also creates payroll headaches. Source deductions and remittances on payments to non-resident employees are subject to special rules. Obligations under Canadian payroll laws must also be reconciled with the terms of any tax treaty between Canada and the country the employee comes from.

What This Article Does & Doesn't Cover

Fees, commissions and other payments to a non-resident "in respect of services rendered in Canada" are subject to 15% withholding under Sec. 105(1) of the *Income Tax Regulations*. While it covers a lot of ground, Sec. 105(1) doesn't cover employment. This article does. Specifically, the article is about remuneration paid to non-resident employees who provide services in Canada.

What the Law Requires

As a sovereign country, Canada has the right to tax any person who earns employment income within its borders. Of course other countries have the same rights, including countries where residents of Canada work. As a result, residents of one country who work in another can be taxed by both their home and host country.

Many countries negotiate bi-lateral tax treaties to protect their residents. Although terms differ, tax treaties essentially eliminate double taxation and provide reciprocal treatment. Example: Canada promises to afford residents of India who work in Canada special tax treatment and India promises the same treatment to Canadian residents who work in India.

Tax treaties override the domestic laws of the signatory nations. In the context of payroll, this means that the usual obligation of employers to withhold and remit is subject to the terms of tax treaties between Canada and the non-resident employee's home country.

How to Comply

The primary source of guidance on how Canadian rules apply to non-resident employees comes from CRA Income Tax Circular No. 75-6R2 (IC 75-6R2). Caveat: The CRA can't make laws, it can only interpret them. But IC 75-6R2 carries enormous weight because it's the document that CRA uses to process returns on non-resident employees. The best way to handle the requirements is to ask 4 questions:

2. **If So, Is the Employee a Non-Resident?**

Once you've determined that the worker is an employee, you must verify that he or she is a non-resident. Keep in mind that for tax purposes, residency is based not on where the person lives but where he/she earns income.

3. **Which Country Does the Employee Come From?**

You must separate your non-resident employees into 2 groups:

Employees from Tax Treaty Countries: If the employee comes from one of the more than 90 countries with which Canada currently has a tax treaty, withholdings are based on the terms of the tax treaty rather than Canadian payroll laws.

Employees from Non-Tax Treaty Countries: If the non-resident employee's home country doesn't have a tax treaty with Canada, you make tax, CPP/QPP and EI withholdings and remittances the way you would if the employee were a Canadian resident.

4. **Has the Employee Gotten a Waiver or Exemption?**

Although they eclipse Canadian payroll laws, tax treaties are not self-actuating. To take advantage of the special tax treatment in the treaty, the employer or employee must secure what's called a waiver of withholding (or an exemption from CPP deductions based on a Social Security treaty between Canada and the employee's home country) from the nearest CRA Tax Services Office. The application is due 30 days before Canadian employment begins or initial payment is made.

Processing Payroll

Unless and until the waiver is secured, standard withholding rules apply. In other words, you make the same tax, CPP and EI deductions and remittances for non-residents that you do for your Canadian employees. You also have to prepare and file T4s for all non-resident employees, regardless of whether they get a waiver. Non-resident employees are also required to file a Canadian tax return for the employment income they earn in Canada by April 30 of the following calendar year and attach a copy of the T4 (Copy 3) to the T1. And, of course, employers who fail to make proper deductions and remittances for non-resident employees are subject to the usual tax penalties that apply to deductions and remittances of resident employees.

A Case Study

Remember that either the employer or employee must apply for a waiver to get the benefit of the special withholding rules in the tax treaty. Whether CRA approves the waiver depends on the employee's situation and the terms of the particular treaty. Although we'll use an example of a U.S. resident, you can apply the same approach to non-resident employees from other countries.

To start, we need to consider what the U.S. Canada Tax Treaty says about the taxation of income earned by Americans in Canada for employment services provided in Canada. Under Article XV of the Treaty, there are two conditions when such remuneration might not be taxable in Canada:

Condition 1: Total remuneration for the calendar year in which the employment occurs is $10,000 (CAN) or less; OR

Condition 2: The employee isn't "present" in Canada for at least 183 days in the calendar year, AND the remuneration is not "borne by":

An employer who is a resident of Canada; OR

A "permanent establishment" or "fixed base" that the employer has in Canada.

EXAMPLE

Amory Cahn is a U.S. resident and employee of Ford Motor Co. (Ford) who works in Buffalo, NY. In 2015, Ford posts—or seconds—Amory to Ford Motor Co. of Canada (Ford Canada) in Toronto where he works from Jan. 1 to March 31. During this period, Ford Canada pays wages directly to Amory and bills Ford for the cost. Amory returns to Buffalo on April 1, 2015, and works there for the rest of the year. But every Monday, Wednesday and Friday, he drives to Toronto to meet with Ford Canada officials for 30 minutes. He spends no other time in Canada in 2015. Amory gets paid $5,000 per month in the currency of the country where he's working. Ford Canada applies for a waiver of withholding for Amory under the U.S.-Canada Tax Treaty for Jan. through March.

We know that Amory is an employee, that he's not a resident of Canada and that his home country has a tax treaty with Canada. Now Ford Canada or Amory must secure a waiver to benefit from the exemption from withholdings under the treaty. Will CRA approve a waiver for Amory?**Calculating Source Deductions**

Condition 1: Amory's remuneration from Ford Canada for 2015 is $15,000 (C) (3 months x $5,000), over the $10,000 threshold. So if Amory has any chance of getting that waiver, he'll have to do it under Condition 2.

Condition 2—First Hurdle: To satisfy Condition 2, Amory must clear two hurdles. First, he can't be present in Canada more than 183 days during the year. Amory's employment in Canada runs from Jan. through March—91 days. That's below the 183-day threshold. So it looks like he clears the "presence" hurdle. But hold on. What the treaty actually says (Art. XV(2)(b)) is that remuneration is taxable in the host state—Canada in this case—if the employee is "present in [Canada] for a period or periods not exceeding in the aggregate 183 days in that year." In other words, you count all days an employee was "present" in Canada, regardless of whether they were consecutive.

Amory's employment in Toronto lasted only 91 days. But he also came to Toronto for meetings on Mondays, Wednesdays and Fridays from April through Dec. That's roughly 108 days. These meetings only took 30 minutes. Do they count as days present? Unfortunately for Amory, they do. According to IC 75-6R2, "when considering the 183-day rule, the word 'day' includes any day or part of a day . . . the person was physically present in Canada, regardless of the number of hours present." So Amory's total days present in Canada for 2015 is 199 (91 + 108), over the 183-day threshold. So Amory won't get the waiver.

Condition 2—Second Hurdle: Let's assume that from April to Dec., Amory visits Ford Canada officials in Toronto only once a week, or 36 times in the year. Now his total days present for 2015 would be 127, below the 183-day threshold. So he'd clear hurdle 1. Now he must clear hurdle 2. For the tax treaty to apply, the remuneration can't be borne by an employer who is a resident of Canada or by a permanent establishment or fixed base in Canada of that employer.

The “employer” is the person who pays, i.e., physically gives the employee his wages. From Jan. through March, that’s Ford Canada. But the treaty also talks about who the wages are “borne by.” If Ford Canada is also bearing Amory’s wages, the waiver won’t apply because Ford Canada is a Canadian resident.

We know that Amory’s remuneration is paid by Ford Canada. Is it “borne by” Ford Canada, too? The answer: No. “Borne by” doesn’t necessarily mean paid by. CRA states in IC 75-6R2 that it means that the expense is allowable as a deduction in calculating taxable income. Remuneration, the CRA continues, “is borne by somebody if they are charged either directly or indirectly, through a management fee or otherwise.” In this case, Ford Canada pays Amory’s wages but bills Ford. So Ford bears the remuneration. As a result, the tax treaty does apply and Amory can get a waiver.

<u>Bottom Line</u>: When U.S. employees are posted at Canadian companies, and vice-versa, the transactions must be deliberately structured to ensure that the tax treaty exemption from withholdings applies. In many cases, this will involve making sure the employee’s remuneration is not borne by the Canadian employer (or U.S. employer if a Canadian resident is seconded to a U.S. company).

Conclusion

One final twist: The rules governing CPP deductions for non-residents are slightly different. Exemption from withholding is authorized not by tax treaties but parallel bilateral Social Security agreements between Canada and the non-employee’s country of residence. Instead of a waiver of withholdings, the employee must file a specific form to CRA to obtain an exemption. For American employees, that’s Form CPT56 (07).