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CANADA-US TAX TREATY: PROBLEMS IMPACTING CANADIAN EMPLOYEES WORKING IN THE US

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The 5th Protocol to the Canada-United States Tax Convention (1980)[1] (the Treaty), which entered into force on December 15, 2008, introduced several significant and highly anticipated changes to the Treaty. There were also several minor amendments made to the Treaty, including one to Article XV that was intended only to be clarifying in nature. There is evidence that some auditors of the Internal Revenue Service (IRS) are interpreting the amendment to Article XV in a manner that goes beyond what was intended by the Treaty negotiators. (There may be situations in which CRA auditors have taken a similar interpretation, but the author is unaware of such and therefore cannot comment.) If a trend begins to develop, this could have major ramifications on cross-border services, particularly intra-group services where Canadian employees are sent to work in the US for short periods of time.

Background

The 5th Protocol amended subparagraph 2(b) of Article XV of the Treaty to change the word "employer" to "person. However, the Technical Explanation ("TE") of the 5th Protocol reads as follows:

New Subparagraph 2(b) refers to remuneration that is paid by or on behalf of a "person" who is a resident of the other Contracting State, as opposed to an "employer". This change is intended only to clarify that both the United States and Canada understand that in certain abusive cases, substance over form principles may be applied to recharacterize an employment relationship, as prescribed in paragraph 8 of the Commentary to Article 15 (Income from Employment) of the OECD Model. Subparagraph 2(b) is intended to have the same meaning as the analogous provisions in the U.S. and OECD Models. [Emphasis added]

The Canada Revenue Agency (CRA) has also addressed this issue in writing at the 2008 TEI-CRA Liaison Meetings and has stated that "[w]hether the word "person" or the word "employer" is used in subparagraph 2(b) of Article 15 (Income From Employment) in Canada's income tax conventions, the intention is to determine who, in fact, is exercising the functions of employer. In making this determination, the CRA generally will refer to principles developed under Canadian jurisprudence and the Quebec Civil Code" (Canada Revenue Agency, CRA Views, Conference 2008-0300571C6 "5th Protocol - changes to Article 15(2)(b)" (9 December 2008) (TaxNetPro)).

Hypothetical Scenario

Consider a corporation resident in Canada (Canco) which has a wholly-owned subsidiary in the US (US Opco). Canco is in the business of providing engineering services and employs a number of full-time engineers. US Opco carries on the same business as Canco, solely in the US, and has its own staff of engineers. However, Canco has a few engineers (Canco Employees) with unique skill sets who, on occasion, are sent down to job sites in the US to assist US Opco and its engineers. At no time do the Canco Employees have an employee-employer relationship with US Opco, in substance or in form, while performing their duties of employment in the US. The arrangement is not in the nature of a secondment or employee sharing and is purely a contract of services between Canco and US Opco. US Opco reimburses Canco for the remuneration paid to the Canco Employees in respect of their time spent in the US. The Canco Employees spend less than 90 days in the US each year, but do earn more than $10,000. Canco does not have a permanent establishment (PE) in the US.

There is no dispute between the relevant taxpayers and the IRS as to there being a possible employee-employer relationship between Canco Employees and US Opco. In addition, as a consequence of the reimbursement, there is also no dispute as to the fact that US Opco bears the cost of the Canco Employees' wages with respect to their duties exercised in the US.

Article XV of the Treaty Prior to the 5th Protocol

Prior to the 5th Protocol, subparagraph 2(b) of Article XV of the Treaty read as follows:

The recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days in that year and the remuneration is not borne by an employer who is a resident of that other State or by a permanent establishment or a fixed base which the employer has in that other State. [Emphasis added]

Under the pre-5th Protocol version of subparagraph 2(b) of Article XV ("Article XV(2)(b)"), there would not have been a debate, in respect of the hypothetical scenario above, as to whether the Canco Employees were entitled to exemption from US income tax on their remuneration earned in respect of duties exercised in the US. Since Canco is a resident of Canada and there is no dispute as to it being the "employer" of the Canco Employees at all relevant times, the conditions in the pre-5th Protocol version of Article XV(2)(b) would have been met by the Canco Employees.

The Issue

Upon an IRS audit of taxpayers with circumstances similar to those described in the hypothetical scenario above, some Canadian residents (employees) are being challenged on their claims for treaty benefits in accordance with Article XV(2)(b) of the Treaty. This is happening in spite of the TE, the CRA announcements on this issue and the Commentary to Article 15 of the 2010 Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (OECD and the OECD Model Treaty) (OECD, Model Tax Convention on Income and on Capital, Condensed Version (OECD Publishing, 2010)). Article XV(2)(b) states that the remuneration must not be paid by, or on behalf of, a person who is a resident of the US. Since Canco is reimbursed by US Opco and US Opco is claiming a deduction in computing its income for US tax purposes, the author has come across situations where the IRS considers the remuneration to be paid either by a person resident in the US or on behalf of a person resident in the US. This, of course, is not consistent with the TE or the CRA announcements on this topic. It is also inconsistent with the application of that same provision for pre-5th Protocol taxation years.

General Comments

Most multinational enterprises (MNE) provide a wide variety of services to their members. These intra-group services include a wide range of potential services in respect of many functions, including technical services such as engineering. Whether such services are formalized in a written contract or whether a mark-up is appropriate does not have any bearing on the nature of the relationship between the employees of the MNE and its member company. There may be a transfer pricing issue if proper consideration is not charged by the MNE for that particular service. There may also be PE issues and withholding tax issues, since the MNE, say in our hypothetical scenario, may be considered to have taxable income which is effectively connected to a trade or business in the US. Regardless of the other issues, this does not impact the nature of the relationship between the employees of the MNE and other corporations within the corporate group.

In light of the TE and the recent work done by the OECD regarding Article 15 of the OECD Model Treaty, it is generally understood that, for Treaty purposes, the determination of employee-employer relationships is primarily a question of fact. Tax administrations may ignore the formal legal employment relationship and instead analyze the functions performed to determine who the true employer is. The true employer is generally understood to be the person having the rights to the work as well as the one who bears significant responsibilities and risk. In Canada, several tests for determining employee-employer relationships have been established under Canadian jurisprudence and should be referred to in determining whether such a relationship exists (i.e., tests of control, integration, economic reality and specific results). (See generally Wiebe Door Services Ltd v MNR, 87 DTC 5025 (FCA); Sagaz Industries Canada Inc v 671122 Ontario Ltd, 2001 SCC 59; Lawrence Wolf v The Queen, 2002 DTC 6853 (FCA); Dynamic Industries Ltd v The Queen, 2005 FCA 211; OLTCPI Inc v MNR, 2010 FCA 74.) The change in wording in Article XV(2)(b) as a consequence of the 5th Protocol ensures that the IRS and CRA can challenge those employment situations where it is not clear who the real employer is. It is evident that the Canada and US Treaty negotiators felt a change in wording from "employer" to "person" would give their tax administrations more flexibility in challenging those borderline cases or abusive cases, even though one could question why such an amendment was necessary in light of all the work done by the OECD on Article15 in the context of the meaning of the term "employer." Regardless, the 5th Protocol amendments were not intended to allow either tax administration to deny Treaty benefits where there is clearly no employee-employer relationship between the Canadian employee and the person bearing the cost of that remuneration. If either tax administration were to establish a pattern of taking this approach to interpreting the new Article XV(2)(b) in this manner, it would risk rendering the Treaty exemption provision somewhat meaningless in circumstances where the source (or host) country is paying for a contract of service, whether by straight reimbursement or a fee that includes a mark-up.

Generally speaking, the cross-border utilizations of employees in cases similar to the hypothetical scenario described above are characterized as either secondments or as employee-sharing (i.e., an employee-employer relationship is established with the temporary employer in the US) or as a transfer of service. Where the scenario is in fact a transfer of service, which is what the author has described in the hypothetical scenario above, then the transfer must take into consideration the amount that an arm's-length entity is prepared to pay for such a service in comparable circumstances. Often, that price will not only include the service provider's (e.g., Canco) costs, but also an element of profit. Whether an element of profit is appropriate will come down to a question of economic alternatives to the recipient of the service. The fact that only a reimbursement of costs was charged by Canco to US Opco for the services it provided is not relevant regarding the ultimate taxation of the employment remuneration of Canco Employees. That is, a reimbursement of Canco's costs does not change the nature of the Canco Employees' relationship with US Opco from a transfer of service to an employee-employer relationship. It is the latter scenario, whether in substance or form, that new Article XV(2)(b) is trying to address by denying Treaty benefits to the employees where they have truly changed employers. If Canco should have charged a mark-up on those services, as opposed to a straight reimbursement, then there is a valid transfer pricing issue for the tax administrations to consider.

The most significant fact in the hypothetical scenario above is that it involves a "transfer of service." If a tax administration is not challenging that particular fact, regardless of the fact that no mark-up was charged by Canco, then it should not be denying Treaty benefits to Canco Employees unless those employees are present in their country for more than 183 days. If the IRS establishes a pattern of denying Treaty benefits in the hypothetical scenario described above, then all Canadian companies providing services to US companies, assuming the Canadian company's employees physically perform some of their duties in the US, could be at risk of being taxable in the US. For example, if the US Opco (a "person" resident in the US) is paying (thus claiming a deduction in computing its taxable income) a fee to the Canadian service provider (i.e., Canco) that includes a mark-up as opposed to a straight reimbursement, would the same arguments not be available to a tax administration to deny Treaty benefits to the employees? For example, their interpretation of Article XV(2)(b) would still likely be that the remuneration received by the Canadian service provider's employees is being paid, or the costs are being borne, albeit indirectly through the service fee, by a person resident in the US. Based on a literal interpretation of Article XV, how can one distinguish between a service contract where there is a mark-up and one where there is not? That fact does not seem relevant. The author is not aware of any evidence that the IRS would or has denied Treaty benefits in a scenario involving a mark-up, but based on some early evidence regarding their approach taken in the hypothetical situation, it is not clear to the author how they could distinguish the two scenarios. As a result, this issue could potentially be problematic on a larger scale.

Conclusion

Hopefully, the cases where the IRS has taken a broad interpretation of the word "person" in Article XV(2)(b) are isolated cases and will not become common practice. The reality is that if a tax administration is offended by losing source (or host) country taxation rights where an entity ("person") resident in its state bears the actual costs of the wages earned in its country by employees of the foreign company, and such employees are not employees of that entity while temporarily working in that country, then the tax administration needs to consider other audit avenues such as whether the foreign company was carrying on business in its country through a PE. The 5th Protocol amendments to Article XV(2)(b) should not be viewed by either tax administration as an opportunity to circumvent or bypass the extra audit work that might be otherwise necessary in verifying whether a foreign employer had a PE in its state. For greater certainty, in the hypothetical scenario described above, if Canco had a PE in the US as a consequence of the duties the Canco Employees performed in the US, then Article XV would maintain US taxing rights and deny Treaty benefits to the Canco Employees.

The author recommends that tax advisors be prepared to have examples ready to support their arguments with the IRS in the event they are being challenged on this provision. An example that could be helpful would be to describe a situation where the Canadian parent company sent one of its employees to work at the US subsidiary's office for only a few weeks to assist the subsidiary with some year-end accounting functions. Assuming the US subsidiary reimbursed its parent company for the three weeks of wages which we will assume exceeded the $10,000 safe harbour rule in subparagraph 2(a) of Article XV, the IRS would deny Treaty benefits to the Canadian employee under this interpretation of the word "person" in Article XV(2)(b). This example would be similar to the hypothetical scenario above, but might better drive home the message regarding how absurd a broad interpretation of the word "person" in Article XV(2)(b) of the Treaty would be.

In the event assessments of this nature are carried out by either tax administration, recourse should be available through the Mutual Agreement Procedure of the Treaty where the Canadian and US competent authorities will have the opportunity to quickly resolve the matter.

[1] Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, 26 September 1980, SC 1984, c 20, Part I (entered into force 16 August 1984) as amended by the protocols done in 1983, 1984, 1995, 1997 and 2007 (Fifth Protocol, SC 2007, c 32 (entered into force 15 December 2008)).

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