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Canadian tax alert – GES

Update on stock option sourcing and article XV

January 28, 2013

Generally, in determining the Canadian taxable compensation with respect to stock options exercised by a non-resident of Canada, only the portion of the stock option benefit attributable to employment services performed in Canada will be taxable in the year of exercise. This traditional Canadian position on the appropriate sourcing period for determining such taxable portion (namely, "year of grant") has not been in line with the position taken by other countries (including the United States).

In the latter part of 2012, the Canada Revenue Agency (CRA) issued two technical interpretations that, respectively, (1) adopt the Organisation for Economic Co-operation and Development (OECD) default stock option sourcing position of "grant date to vesting date" for domestic (i.e., non-treaty) purposes, and (2) clarify the CRA's interpretation of the exemption in article XV(2)(b) of the Canada-United States income tax convention (the Treaty), in the context of stock option compensation.

The CRA's default sourcing method is changed

Historically, the CRA's default position was that absent clear documentary evidence to the contrary, and absent any specific treaty provisions to the contrary (such as article XV of the Treaty, which imposes grant to exercise sourcing), options were presumed to be awarded for services rendered prior to the date of grant, and thus were sourced based on the employee's workdays during the year of grant. For example, where an individual was residing and working in Canada in the year of grant (Year 1), left Canada in Year 2, had the options vest in Year 4 and exercised the options in Year 6, 100% of the benefit would be taxable in Canada. Such presumption could be rebutted, however, by demonstrating that the options were in fact granted for future services, so as to warrant a more appropriate sourcing method (such as "grant date to vesting date" or "grant date to exercise date").

This position did not correspond with the OECD default position of "grant date to vesting date" sourcing, as indicated in the commentary to article 15 of the OECD model treaty. Neither did it correspond to the sourcing position taken by other countries, including the United States, thus potentially leading to double taxation or, potentially, a windfall, depending on the employee's fact pattern.

At the same time, over the past few years, various CRA officers had informally suggested that they were becoming receptive to "grant date to vesting date" sourcing. This change has now been officially confirmed in its published technical interpretation of September 25, 2012[1]:

[1] CRA document no. 2012-0459411C6.

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> *"… a stock option benefit is generally presumed to relate to the period of employment that is required as a condition for the employee to acquire the right to exercise the option (i.e., the "vesting period"). Further, a stock option benefit is generally presumed not to relate to past services, unless there is evidence to indicate that past services are relevant in the particular circumstances."*

This position applies for options exercised after 2012. For options exercised before 2013, CRA officers have informally indicated that the taxpayer has the choice of either applying the new "grant date to vesting date" position, or the old "year of grant" position.

The CRA's interpretation of Treaty article XV(2)(b)

The CRA's July 6, 2012 technical interpretation[2] considered the scenario of a U.S. resident employee of a U.S. corporation (USCo) who was sent on a temporary basis to Canada to perform services for USCo's Canadian parent company (CanCo). The employee remained on U.S. payroll and did not become a Canadian resident at any time in the three-year period during which services were occasionally performed in Canada. The U.S employee remained an employee of USCo and was not at any time an employee of CanCo in substance or in form. USCo did not carry on business or have a permanent establishment in Canada.

The technical interpretation indicated the following:

1. The default position under Canadian domestic rules is to source the benefit on the basis of "services rendered in the year of grant". (As noted above, this default position was subsequently revised.)
2. Under article XV of the Treaty, employee stock options are instead sourced over the period from grant date to exercise date.
3. If sourcing in accordance with the Treaty results in a greater reportable stock option benefit than sourcing in accordance with domestic rules, the taxpayer can elect the domestic sourcing position instead. (The principle that a treaty can only provide relief and cannot give Canada the right to tax an amount that is not taxable under its domestic law was confirmed.)
4. In determining whether the Canadian source income is exempt from Canadian taxation under article XV(2)(b) of the Treaty, on the basis that the costs of remuneration are not "borne" by a permanent establishment in Canada, one must look at the employee's factual employer (i.e., which entity exercises the direction and control over the employee) and determine whether such factual employer has a permanent establishment in Canada. In this case, the factual employer was considered to be USCo which did not have a permanent establishment in Canada.
5. For purposes of article XV(2)(b) and the question of whether the costs of remuneration are paid by a person who is resident in Canada, the relevant "payer" must be both a (direct or indirect) payer of the compensation as well as a factual employer of the employee. In this case, USCo was considered to have "paid" the remuneration, on the basis that it was both the factual employer and had fully reimbursed CanCo for the option benefit. As a result, the employee was entitled to claim the XV(2)(b) treaty exemption. If such reimbursement had not occurred: while CanCo, as issuer of the shares, would have generally been considered the economic payer of the stock

[2] CRA document no. 2012-0440741I7.

option benefit, it would not be considered the “payer” for purposes of XV(2)(b), as it was not the factual employer.

6. For purposes of determining which entity has the payroll obligation to report and withhold income and social security taxes in respect of the option benefit, one only looks at the (direct or indirect) economic payer of the compensation, and not whether such payer is also a factual employer. Thus, had CanCo not been reimbursed by USCo for the option benefit, CanCo, as payer of the compensation (i.e., issuer of the shares), would have had the obligation to withhold taxes in respect of the benefit and report the benefit on the employee’s T4 slip, even if it is not the factual employer. In this case, USCo reimbursed CanCo for the option benefit and, as such, USCo had the Canadian payroll obligations.
7. The CRA concluded that the U.S. resident had Canadian source income but was exempt under XV(2)(b) of the Treaty. As a result, USCo could apply for a waiver from withholding taxes on such income. If a waiver is not obtained, then USCo would be required to withhold and remit Canadian taxes on the Canadian source income, even if such income was treaty exempt. The employee would then have to file a Canadian income tax return in order to claim a refund.

While this technical interpretation specifically dealt with stock options, the principles should equally apply to other forms of compensation.

Can we assist?

If you have any questions concerning the issues discussed in this GES alert, please feel free to contact your Deloitte representative or one of the GES tax professionals listed on this alert.

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