International Fiscal Association Conference

The Fifth Protocol to the Canada-US Treaty-Part II

JOY MURAD, CA, MBA,TEP

Montreal, May 12, 2008

The Fifth Protocol to the Canada-US Tax Treaty-Part II

- Employee Stock Options
- Pre-Emigration Gains
- Retirement Plan Contributions
- Exempt Organizations

EMPLOYEE STOCK OPTIONS

CROSS BORDER TAX ISSUES
AND THE PROTOCOL

EMPLOYEE STOCK OPTIONS

- Timing of Recognition of Benefit
  - Grant date
  - Vesting or irrevocable vesting date
  - Exercise date
  - Disposition of shares date
  - Different parts of benefit taxed at different times
  - State of residence versus state of source
  - Carry forward or carry back of foreign tax credits

EMPLOYEE STOCK OPTIONS

- Sourcing of the employment benefit
  - Article XV cedes the right to tax to the source state (with exception in paragraph 2)
    - Employment income paid when the employee is present in source state; and
    - Employment income realized before or after such presence derived from services in source state in a given year
  - Domestic sourcing versus treaty sourcing
  - Relief under “Elimination of Double Taxation” article is linked to relief under domestic laws.

EMPLOYEE STOCK OPTIONS

- Employment income versus capital gain
- Article XIII does not allow source taxation of the gain (versus Article XV)
- Double taxation or dual exemption situations
- Generally dividing time is time of exercise of option (when employee becomes a shareholder)

EMPLOYEE STOCK OPTIONS

- To which services does the option benefit relate?
  - Reward for previous performance?
  - Incentive for future performance?
  - Factual/contractual issue
  - Protocol attempts to deal with this apportionment issue

EMPLOYEE STOCK OPTIONS

- Canada-US context: on exercise or later
- Current CRA position: Employment benefit is attributable to employment services rendered in the “year of grant”, absent strong evidence to contrary
- Canadian case law
- US position: Employment benefit is attributable to employment services rendered between grant and vesting dates
- Different sourcing rules in the two countries can lead to double taxation

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- Paragraph 6(a) of Annex B

> "Subject to subparagraph 6(b) of this Note, the individual shall be deemed to have derived, in respect of employment exercised in a contracting state, the same proportion of such income that the
>
> Number of days in the period that begins on the day the option was granted, and that ends on the day the option was exercised or disposed of, on which the individual's principal place of employment for the employer was situated in that contracting state
>
> Divided by
>
> Total number of days in the period on which the individual was employed by the employer"; and

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- Paragraph 6(b) of Annex B

> "Notwithstanding subparagraph 6(a) of this Note, if the competent authorities of both contracting states agree that the terms of the option were such that the grant of the option will be appropriately treated as transfer of ownership of the securities (e.g. because the options were in-the-money or not subject to a substantial vesting period), then they may agree to attribute income accordingly."

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- Relevant period is grant to exercise, not vesting
- Allocation based on where individual's "principal place of employment is situated".
- Principal place of employment is not defined
  - General meaning is 50% or more
  - Where employee performs services 50% or more of the time
  - Location where employee reports for work 50% or more of the time
  - Location from which employee receives direction from employer 50% or more of the time
  - Is the 50% to be applied over a calendar year or each day or week?

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- Limited to employees working for a particular employer (corporation or MFT) or a "related entity". The *Income Tax Act* (Canada) (ITA) provisions apply to broader situations
- "Related" is not defined in either the Protocol or the Annex
- Exception in 6(b) requires CA agreement, not clear when and how it will apply and how apportionment will be made.
- Principal place of employment in a third state?
- Inconsistent with the OECD position

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- OECD position (Policy Study No. 11)
  - "Employee stock options should not be considered to relate to any services after the period of employment that is required as a condition for the employee to acquire the right to exercise the option" (i.e. vesting date)
  - "Employee stock options should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period"
  - Generally allocation is based on the number of workdays exercised in a state.

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

TAXES IMPOSED BY REASON OF DEATH

- US situs property under US rules, hence subject to US estate tax
- Employment income in the year of death
- No foreign tax credit available under article XXIX-B.
- Currently, FTC against Canadian tax payable is only allowed:
  - On income, profits or gains arising in the US (XXIX-B(6)(a)(i))
  - On income, profits or gains *from property* situated in the U.S. (XXIX-B(6)(a)(ii)-where gross estate exceeds US$1.2 M)

PROTOCOL: ANNEX B EMPLOYEE STOCK OPTIONS

- Paragraph 7(a) of Annex B
  - Employment income in respect of the share or option shall be treated, for the purpose of clause XXIX-B 6(a)(ii), to be income from property situated in the U.S.
  - This change ensures Canada will give a FTC for US estate tax
  - No Quebec FTC

PROTOCOL ARTICLE XV(2)(b) EMPLOYEE STOCK OPTIONS

- Changes to Article XV(2)(b)
- "Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a contracting state in respect of an employment exercised in the other contracting state shall be taxable only in the first-mentioned state if:

(b) the recipient is present in that other state for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and the remuneration is not paid by, or on behalf of, a person who is a resident of that other state and is not borne by a permanent establishment in that other state"

PROTOCOL ARTICLE XV(2)(b) EMPLOYEE STOCK OPTIONS

- Meaning of “borne by”
- Can escape source state taxation under article XV(2)(b)
- OECD Commentary: where remuneration is “not deductible” merely because of its nature, this will not be sufficient to conclude that the remuneration is “not borne by” a PE of the employer in the other state
- Proper test should be whether any deduction otherwise available for that remuneration would be allocated to the source state
- Wording change to “paid by”

PRE-EMIGRATION GAINS

PROTOCOL CHANGES TO ARTICLE XIII

PRE-EMIGRATION GAINS

- Article XIII(5) no longer gives Canada the right to tax post departure gain for property subject to the departure tax
- For pre-departure gain, article XIII(7) provides for election whereby individual is deemed to have disposed of the property for US tax purposes immediately before the Canadian deemed disposition

PRE-EMIGRATION GAINS

- Individuals can continue to defer paying tax in Canada until an actual disposition
- Current ITA 126(2.21) is still relevant for moves to other countries

PRE-EMIGRATION GAINS

- Election creates a disposition for a US citizen, a green card holder, or taxpayers who elect to be taxed as full year residents of the US in the year of the move
- This change is effective for Canadian residency terminations after September 17, 2000, retroactive election required

PRE-EMIGRATION GAINS

EXAMPLE

- FMV Canco Shares on Departure 600,000
- ACB 100,000
- FMV on Actual Sale 700,000
- Canadian capital gain (24%)
  - 500,000 pre-departure
  - 100,000 post-departure
- U.S. capital gain (15%) 600,000

PRE-EMIGRATION GAINS

PRE-PROTOCOL
FEDERAL

	Pre Departure	**Post Departure**
	$60,000	$21,500
FTC	(60,000)	
	NIL	
FTC		(15,000) (max)
		$6,500

Subsection 126(2.21)
Article XXIV(3) resourcing
Non resident surtax

PRE-EMIGRATION GAINS

PRE-PROTOCOL
QUEBEC

	Pre Departure	**Post Departure**
	$60,000	
FTC	(15,000)	
	$45,000	

(QTA 772.9.2)

PRE-EMIGRATION GAINS

Pre-Protocol
United States

	Pre Departure	**Post Departure**
US Tax	**----**	**$90,000**
US State Tax?		

PRE-EMIGRATION GAINS

POST PROTOCOL WITH ELECTION

	Pre Departure	Post Departure
FEDERAL	60,000-DEFERRED	NIL
QUEBEC	60,000-DEFERRED	NIL
US	NIL	15,000

PRE-EMIGRATION GAINS

- Mexico
- Korea
- Finland
- Ireland
- Romania
- Belgium
- Venezuela
- UK (Protocol)
- Ireland
- Peru
- Norway
- Australia (Protocol)
- Germany
- Czech Republic

RETIREMENT PLAN CONTRIBUTIONS

PROTOCOL CHANGES TO
ARTICLE XVIII

RETIREMENT PLAN CONTRIBUTIONS

- Current treaty
  - Taxation of distributions from pension plans
  - Deferral of taxation of income accruing in a foreign plan
- Protocol
  - Deduction of contributions in certain cross border situations

RETIREMENT PLAN CONTRIBUTIONS

- New provisions apply to a “Qualifying Retirement Plan” (QRP)
  - Employer based plan (defined in new Art. XVIII(15) & Annex B)
  - E.g. Canadian registered plan, DPSP or group RRSP
  - E.g. US qualifying plan (incl. 401(k) plan)
  - Does not include individual plans like RRSP’s, RRIF’s and IRA’s, unless derived exclusively by rollover contributions from employer based plans
  - Employee will be able to claim a deduction for contributions in the other country

RETIREMENT PLAN CONTRIBUTIONS

- "Commuters" (New Art. XVIII(10))
  - Individual is resident of country A
  - Works in country B
  - Employer in country B
  - Contributes to QRP in country B
  - Deduction available in country A
  - E.g. Individual commutes to work in the US, contributes to US employer's 401 (k) plan. Deduction is available in Canada, limited to RRSP deduction limits (net of actual contributions to RRSP)

RETIREMENT PLAN CONTRIBUTIONS

- "Short-Term Assignees" (New Art. XVIII(8))
  - Individual moves to country B from country A
  - Short term work assignment in country B, 5 years or less
  - Contributes to country A QRP
  - Deduction available to employee in country B
  - Employer contributions deductible in computing its profits in country B
  - Deduction limited to amount deductible under country A rules
  - Individual participated in plan immediately before assignment
  - E.g. Canadian moves to US and continues to contribute to employer's RPP in Canada, will obtain deduction in US, subject to deduction limits for Canadian RPP's

RETIREMENT PLAN CONTRIBUTIONS

- US citizens living in Canada (New Article XVIII(13))
  - US citizen/Canadian resident working in Canada
  - Participates in Canadian QRP
  - Deduction available in US
  - Not much impact
  - Limited to deduction available in Canada under the QRP

EXEMPT ORGANIZATIONS

PROTOCOL CHANGES TO ARTICLE XXI

EXEMPT ORGANIZATIONS

- Current Treaty Provisions
  - 1) Religious, scientific, literary, educational or charitable organization resident in one state, is exempt from tax in source state on non-business income
  - 2) Pension or retirement benefit trust, company or organization resident in one state, is exempt from tax in source state on interest & dividends

EXEMPT ORGANIZATIONS

- Current Treaty Provisions
  - Interest & dividend exemption also applies to a trust, company, organization or arrangement ("Fund", or intermediate entity) , resident in one state and which earns income exclusively for the benefit of an investor described in (2) above
  - Entity must generally be exempt from income taxation in state of which it is resident
  - Commentary (1995 Protocol): Not intended to preclude an entity that "was not taxed in a taxable year".
  - E.g. Elected pension master trust

EXEMPT ORGANIZATIONS

- Current Treaty Provisions
  - Interest & dividend exemption is not available to a “Fund” with category (1) investors, i.e., charitable organizations would lose treaty benefits if investment is made through an intermediate entity
  - IRS : Canadian Fund with both categories of investors is not eligible for the exemption
  - Fund with more than one category (2) investor?

EXEMPT ORGANIZATIONS

- Protocol
  - Interest & dividend exemption will be available to a “Fund” that earns income exclusively for the benefit of either one or both categories of exempt entities
  - Fund must generally be exempt from income taxation in state of which it is resident. No change to 1995 Commentary
  - New LOB provisions will apply to the “Fund” through its investors (XXIX A(2)(g), (h) and (i))