Global Rewards Update:
Canada — stock option benefit sourcing and
Article XV(2)(b) of the Canada-U.S. Income Tax Convention

February 2013

Summary

Generally, in determining an employee’s Canadian taxable compensation with respect to stock options exercised by a nonresident 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. However, the 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 (1) adopt the Organisation for Economic Co-operation and Development (OECD) default stock option sourcing position of grant to vest for domestic (i.e., nontreaty) purposes, and (2) clarify CRA’s interpretation of the exemption in Article XV(2)(b) of the Canada-U.S. Income Tax Convention (the “Treaty”), in the context of stock option compensation.

CRA’s default sourcing method

In its technical interpretation of September 25, 2012, Allocation of Cross-Border Employee Stock Options (Document No. 2012-0459411C6), the CRA revised its default sourcing method for stock option benefits. Traditionally, the CRA’s default position was that stock options were presumed to be awarded for services rendered prior to the date of grant, and thus to be sourced based on the employee’s workdays during the year of grant, unless there was clear documentary evidence to the contrary or there are specific Treaty provisions to the contrary that impose grant-to-exercise sourcing. For example, where an individual was residing and working in Canada in the year of grant (“Year One”), left Canada in Year Two, had the stock options vest in Year Four, and exercised the stock options in Year Six, 100 percent of the stock option benefit would be taxable in Canada. Such presumption could be rebutted, however, by demonstrating that the stock options were in fact granted for future services, so as to warrant a more appropriate sourcing method (e.g., grant to vest or grant to exercise).
However, this position did not correspond with the OECD’s default sourcing position of grant to vest. Neither did it correspond to the sourcing position taken by other countries, thus potentially leading to double taxation or, potentially, a windfall, depending on the employee’s situation.

At the same time, over the past few years various CRA officers informally suggested they were becoming receptive to grant-to-vest sourcing. This change has now been officially confirmed in the CRA’s published technical interpretation of September 25, 2012, whereby it states:

“(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 to stock options exercised after December 31, 2012. For stock options exercised up to and including December 31, 2012, CRA officers have informally indicated that taxpayers have the choice of either applying the new grant-to-vest position or the old grant-year position.

Note that the technical interpretation did not address the sourcing of other forms of deferred compensation, such as restricted stock units (RSUs). There is limited guidance on this, but it is reasonable to expect that the CRA will accept the OECD position of grant-to-vest sourcing on other types of deferred compensation since it has adopted the OECD position on stock option benefits.

**CRA’s interpretation of Article XV(2)(b) of the Treaty**


Specifically, it considered the scenario of a U.S. resident who was an employee of a U.S. corporation (USCo) and was sent on a temporary basis to Canada to perform services for a Canadian parent company (CanCo). The employee remained on U.S. payroll and did not become a Canadian resident at any time over a three-year period during which services were performed in Canada. The U.S. employee remained an employee of USCo and was not at any time a common law (“factual”) employee of CanCo. USCo did not carry on business in, nor have a permanent establishment in, Canada.

While this interpretation only dealt specifically with the Treaty, most of Canada’s tax treaties have language similar to Article XV(2)(b) of the Treaty (except where noted below). As a result, the CRA’s analysis can be extended to Canada’s other treaties, and thus its importance is broader than simply the U.S. context.

The CRA made the following comments:

- The technical interpretation indicated that the default position under CRA rules is to source the stock option benefit on the basis of services rendered in the year of grant. (As noted above, this default position

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1 Note that this fact was not pertinent to the interpretation of Article XV(2)(b) of the Treaty
2 In other words, direction and control of the employee remained with USCo. The holding would have been different if such direction and control was transferred to CanCo (e.g., through a secondment of the employee from USCo to CanCo.)
was subsequently revised).

- Under Article XV(2)(b) of the Treaty, employee stock option benefits are instead sourced over the period between grant and exercise.\(^3\)

- If the sourcing under the Treaty results in a greater reportable stock option benefit amount than domestic sourcing, the taxpayer can elect the domestic sourcing position instead. (The principle that the 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.)

- In determining whether the Canadian source income is exempt from Canadian taxation under Article XV, subparagraph 2(b), of the Treaty, on the basis that the costs of remuneration are not “borne” by a permanent establishment in Canada, one needs to look at the employee’s common law (“factual”) employer (i.e., which entity exercises the direction and control over the employee; here, the true employer was deemed to be USCo and not CanCo) and determine if such factual employer has a permanent establishment in Canada.

- For purposes of Article XV(2)(b) of the Treaty and the question of whether the costs of remuneration are paid by a “person” who is a resident of Canada, the relevant “payer” has to be both a (direct or indirect) “payer” of the compensation, as well as a factual employer of the employee. Here, USCo was considered to have “paid” the remuneration because it was both the factual employer and had fully reimbursed CanCo for the stock option benefit. As a result, the employee was entitled to claim the Article XV(2)(b) Treaty exemption. If such reimbursement had not occurred, CanCo, as issuer of the shares, would have generally been considered the payer of the stock option benefit, but it would not have been considered the “payer” for purposes of Article XV(2)(b) of the Treaty, as it was not the factual employer.

Note that this holding is new, as the issue has never been explicitly addressed by the CRA in the past.

- For purposes of determining which entity has the payroll obligation to report and withhold income and social security taxes for the stock option benefit, one only looks at the (direct or indirect) payer of the compensation, and not whether such payer is also a factual employer. Thus, had CanCo not been reimbursed by USCo for the stock option benefit, CanCo, as payer of the compensation (i.e., issuer of the shares), would have the obligation to withhold taxes for the stock option benefit and report the stock option benefit on the employee’s T4 slip, even if CanCo was not the factual employer. If, on the other hand, USCo reimbursed CanCo for the stock option benefit, USCo would have the obligation to withhold taxes for the stock option benefit and report the stock option benefit on the employee’s T4 slip.

- As a result, the CRA concluded that the U.S. resident had Canadian source income, but was exempt under Article XV(2)(b) of the Treaty. As a result, USCo could apply for a waiver from withholding taxes on such income. If a payroll waiver is not obtained, then USCo would be required to withhold and remit Canadian taxes on the Canadian source portion, 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.

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\(^3\) This rule is particular to the Canada–U.S. Income Tax Convention treaty. Most other treaties are silent as to sourcing.
Note that while the July 6, 2012 technical interpretation specifically dealt with stock option benefits, the third to seventh bullets above should equally apply to other forms of compensation.

**Deloitte’s View**

While the CRA technical interpretation on stock option benefit sourcing confirms the direction that CRA officers have been heading toward, it is very helpful to have an official published confirmation that the default stock option benefit sourcing position in Canada will now look to the period between the date of grant and the date of vesting of the stock option benefit. This is in line with the OECD position, as well as the position of many countries, and thus significantly reduces the risk of double taxation of mobile employees.

The other CRA technical interpretation specifies that both the “borne by” and the “paid by” tests in Article XV(2)(b) of the Treaty require that the “bearer” and “payer” of the costs of remuneration also be the common law (factual) employer of the employee. This should expand the situations where a non-Canadian employee is exempt from Canadian taxation on the Canadian workdays portion of compensation, for payments made directly by the Canadian (nonemployer) entity, but reimbursed by the foreign (factual employer) entity.

**Action**

- Companies should update their internationally mobile employee procedures for Canada to ensure that the new stock option benefit sourcing rules are applied to stock option benefit income as of January 1, 2013.
- Companies should inform their expatriates that have been assigned to or from Canada about the new stock option benefit sourcing rules, and the impact these rules might have on expatriates’ income derived from future stock option benefit exercises.
- When determining whether Article XV(2)(b) of the Treaty can be applied, it should be taken into account that the “bearer” and the “payer” of the costs of remuneration should also be the common law (factual) employer of the employee.

**People to contact**

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