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# Managing the Tax Impact of Cross-Border Remote Work Arrangements: A Canadian Perspective

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The rapid and involuntary shift in many sectors to a work-from-home model during the Covid-19 pandemic has demonstrated to both employees and employers that remote work is feasible and employees can be just as productive as working at a traditional work site. The flexibility of remote work can be used by employers to attract and retain key talent, or to more efficiently allocate employees to foreign affiliates without requiring them to physically relocate to another jurisdiction.

While employees and employers alike may benefit from the flexibility of remote working arrangements, the potential tax impact of such arrangements on employers and employees may be significant, and therefore must be carefully considered and managed. This article primarily considers Canadian tax issues *for employers* that arise in both inbound and outbound remote work situations — where an employee of a Canadian employer is working while physically outside of Canada, and where an employee of a Canadian employer is assigned to work remotely from Canada for an affiliated foreign employer — as well as some considerations based on whether the remote work arrangement is requested by the employee versus an assignment by the employer.

Although this article is focused on Canadian tax issues, similar issues may arise in other jurisdictions.

## THE 'NO PE' PRESUMPTION

The discussion below presumes that in most cases employers will want to avoid carrying on business or having a permanent establishment (PE) in a foreign jurisdiction. In Canada, similar to other countries, if a non-resident carries on business in Canada,[1] the non-resident is generally required to pay tax on its income from that business, file a Canadian income tax return, and likely comply with Canadian sales tax rules. If the non-resident is resident in a country with whom Canada has a tax treaty, the non-resident will generally be required to file a Canadian income tax return to the extent it is carrying on business in Canada, but should only be subject to Canadian income tax on profits attributed to a PE in Canada within the meaning of the particular tax treaty. Canada's tax treaties

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[1] The determination of whether a non-resident is "carrying on business" in Canada is generally determined based on common law principles and section 253 of the Tax Act, which extends the meaning of that phrase to include, among other things, the solicitation or offering for sale of anything in Canada, even if the final contract or transaction is completed outside of Canada, and the production, creation, manufacturing, improvement, or other similar actions of anything in Canada, even if the thing is exported from Canada before being sold.

contain the common forms of PEs found in many countries' tax treaties including a fixed place of business (e.g., an office), or having a dependent agent — which in most Canadian treaties is described as a person who habitually exercises in Canada an authority to conclude contracts in the name of the non-resident (other than an agent of ''independent status'').

Conceptually, the attribution of profits to a PE in a foreign country seems simple enough; however, the process of doing so can be complex and uncertain in many cases. The administrative burden can be substantial and disproportionate to the benefit of the remote work arrangement, particularly if the PE results from the work of a single employee — sometimes referred to as a ''micro PE.'' Further, carrying on business in a foreign country, particularly through a PE, exposes the non-resident's worldwide operations to audit and scrutiny of a foreign tax authority.

This article presumes that the employer will generally try to avoid having a PE outside its home jurisdiction; however, this ''no PE'' presumption may not be true for all employers.[2]

## Scenario 1: Virtual Assignment of Canadian Employee to Foreign Employer

The Scenario 1 is becoming more common as we grow accustomed to remote work: the virtual assignment. Under this scenario, a Canadian employer assigns its Canadian resident employee to work remotely for a foreign affiliate and the employee remains in Canada.

A virtual assignment can be structured in different ways, including (1) the employee is seconded to the foreign employer, or (2) the foreign employer retains the Canadian employer to provide services and the services are actually performed by the Canadian employee. In both cases, the Canadian employee will generally be indifferent since they will continue to be subject to Canadian income tax (and presumably not subject to any foreign income tax). However, this scenario poses a number of tax issues for the foreign and Canadian employers: Will the virtual assignment expose the foreign employer to Canadian tax and filing obligations? Which employer will be responsible for payroll deductions from the employee's remuneration? Will transfer pricing rules or sales taxes apply to payments between the employers?

In either case, the key issue in the virtual assignment scenario — which is also important for all of the scenarios in this article — is whether the employee's location will result in the employer being taxable in the employee's jurisdiction. For Canada, that means determining whether the employee's work in Canada results in the foreign employer being considered to carry on business in Canada, and if so, where a tax treaty applies, whether the business is carried on through a PE in Canada. The broad definition of carrying on business in Canada and the rules concerning PEs in tax treaties mean it is essential for employers to carefully consider the working conditions, role, and function of the Canadian employee, and to just as carefully monitor and ensure compliance by the Canadian employee with any guidelines established around their work for the foreign employer. The working conditions include the location of the employee's work — if the foreign employer procures a work space for their employee or reimburses any rental of work space by the employee, would that work space be considered a PE? Should the Canadian employee continue to have access to work space at the Canadian employer's premises? Should the Canadian employee be required to work from home? In terms of the role and function of the employee, an employer must consider how integral the employee is to the core business operations of the employer — a employer in an external-facing sales role may be more high risk than an employee serving a back office function — or whether the employee performs executive functions.

To mitigate the risk of a dependent agent PE in Canada, the foreign employer should expressly provide in writing that the Canadian employee has no authority to enter into contracts on behalf of the foreign employer. Even if the Canadian employee is precluded from executing contracts, there may still be a risk of a dependent agent PE if the Canadian employee plays a significant role in the negotiation of contracts.[3] In that case, the foreign employer should consider and enforce protocols that support the position that persons outside of Canada actually approve and enter into the contracts, and are not merely rubber stamping them.

From a tax administrative perspective, where the Canadian employee is seconded to the foreign employer, it will generally be simpler if the Canadian employee remains on the Canadian employer's payroll and the foreign employer reimburses the Canadian employer for remuneration and other forms of compensation received by the Canadian employee. In

[2] For example, while a ''place of management'' may be a PE under Article V of the Canada-U.S. tax treaty, Article VII provides that no business profits are attributed to a PE if the PE is used merely for the provision of executive, managerial, or administrative facilities or services.

[3] See, e.g., Article 12(1) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (to which Canada is a signatory) and the 2017 OECD model tax convention commentary regarding Article 5(5) at paragraphs 83–84.


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some cases and subject to relevant transfer pricing rules, it may be appropriate for the Canadian employer to charge an administration fee to the foreign employer.

If the virtual assignment is instead structured as a services contract between the Canadian and foreign employers, then once again the Canadian employee can remain on the Canadian employer's payroll, however the Canadian employer should charge a services fee to the foreign employer, and the employers will need to consider arm's-length pricing and documentation requirements under relevant transfer pricing rules. In general, the export of many types of services by a Canadian resident to a non-resident is not subject to Canadian goods and services tax ("GST") provided the non-resident does not carry on business in Canada and is not registered for GST purposes.

If the foreign employer is a "controlled foreign affiliate" to the Canadian employer,[4] then services income earned by the foreign employer in respect of services performed by the Canadian employee may be included in computing the foreign employer's "foreign accrual property income" and attributed to the Canadian employer in the year the income is earned and included in the Canadian employer's income for Canadian tax purposes. Further, even if the foreign employer pays high-rate foreign tax on its services income, the Canadian employer may not be entitled to claim any deduction or credit in respect of foreign tax if the Canadian employer is a Canadian-controlled private corporation because of proposed rules announced in Canada's 2022 federal budget.

Finally, in the rare scenario where the Canadian employee is performing services in Canada to the foreign employer's clients, any payments made by the client to the foreign employer (regardless of where the client is resident) may be subject to a 15% withholding requirement under regulation 105 of the *Income Tax Regulations*. If regulation 105 applies, the foreign employer may obtain a withholding waiver from the Canada Revenue Agency or a refund of the amount withheld if the foreign employer can establish that they do not owe any Canadian income taxes in respect of those services under an applicable tax treaty.

## Scenario 2: Employee Requests to Work in Canada for Foreign Employer

Under scenario 2, a non-resident employee of a foreign employer requests to work in Canada. The tax issues for the foreign employer are similar to those considered for scenario 1; however the foreign employer under scenario 2 cannot rely on its Canadian affiliate to handle payroll matters.

On a practical level, because the employee is presumably requesting the remote work arrangement for personal reasons, the foreign employer may compel the employee to assume their Canadian payroll obligations by requiring the foreign employee to incorporate and operate as a personal services business (PSB). Generally, a personal services business exists where an individual would be considered to be an employee if it were not for the existence of the corporation.

The PSB rules in the Tax Act generally eliminate any tax benefit to incorporation to the employee; however, the PSB can benefit the foreign employer because the employer will be generally relieved of any Canadian payroll obligations on payments to the PSB corporation. Instead, the PSB corporation is required to withhold on remuneration paid to the individual employee. A PSB may not be appropriate, however where a significant portion of the employee's compensation is in the form of stock options or other equity incentives. In that case, it should be considered whether the grant of equity incentives to a non-employee may result in adverse tax implications, e.g. if there is an income inclusion at the time the stock options are granted because the options have value under the Black-Scholes model.

The foreign employer may also feel obliged to prepare the employee for the tax consequences of the employee ceasing to be resident in the foreign country and becoming resident in Canada. One Canadian tax aspect that catches some immigrating employees off guard is that the value received on the exercise or settlement of equity incentives granted to the employee before they immigrated to Canada, may be subject to Canadian tax unless an applicable tax treaty applies to the employee. With the exception of Canada's tax treaty with the United States, Canada's tax treaties are generally silent on how stock option benefits are allocated between Canada and the other treaty country; however, the Canada Revenue Agency has indicated that it will generally follow the principles set out in the OECD commentary in respect of allocating taxing rights on stock options where an employee has migrated after the options were granted.[5] While the allocation of taxing rights may depend on the specific facts and circumstances, the OECD commentary generally provides for an allocation of taxing rights between Canada and the other treaty country

[4] Canada's Tax Act contains a foreign affiliate regime similar to CFC regimes in other countries.

[5] CRA, 2012-0459411C6, "Allocation of cross-border employee stock options" (25 Sept. 2012), referencing paragraphs 12–12.15 of the 2017 OECD Commentary on Article 15; this represents a change in Canada Revenue Agency policy for 2005 and forward.


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proportionate to the time the employee's principal place of employment was in each country during the vesting period of the stock options. Whereas under the U.S.-Canada tax treaty, the time period is between the grant and exercise of the stock options.[6] If Canadian tax does apply, the employee will need to consider whether foreign tax will also apply and whether the employee can claim a foreign tax credit to avoid double taxation.

## Scenario 3: Canadian Employee Working Remotely Outside of Canada

Under scenario 3, the Canadian employee of a Canadian employer is working remotely for their Canadian employer from outside of Canada. This scenario can arise in a number of circumstances: an employee who ordinarily works from home in Canada chooses to travel abroad temporarily (and in some cases without the employer's knowledge!); the employee requests to relocate to a foreign country on a more permanent basis; or the employer requests that the employee relocate to a foreign country on a temporary or permanent basis.

In this case, the Canadian employer will need to engage a foreign tax advisor to determine whether the employee's presence in the foreign country exposes the Canadian employer to any foreign tax, reporting, or payroll requirements. Even if the employee is not subject to foreign income tax because of a tax treaty, remuneration paid to the employee may nevertheless be subject to foreign payroll withholding requirements. Given the potential tax consequences to the Canadian employer, Canadian employers should be wary of their employees working outside of Canada.

If the employee will cease to be resident in Canada and become tax resident in another country, then the Canadian employer may feel obliged to prepare the employee for the tax consequences of ceasing to be resident in Canada, particularly so where the employee is relocating at the request of the Canadian employer. The determination of whether an individual ceases to be resident in Canada generally depends on the individual's facts and circumstances, deeming rules in the Tax Act, and tie breaker rules in any applicable tax treaty.

Assuming an individual employee will cease to be resident in Canada, the employee will generally be deemed to dispose of all of their assets at fair market value immediately before they cease to be resident in Canada. The deemed disposition is intended to allow Canada to tax any gains on the employee's assets that accrued while the employee was a Canadian resident if Canada will not otherwise be in a position to collect tax at a later date when the employee disposes of the assets. Certain properties are excluded from this deemed disposition rule, for example, real property situated in Canada is excluded because any gain realized by a person on the disposition of such property is generally subject to Canadian income tax even if the person is not resident in Canada. Various rights and interests are also excluded including rights under a registered retirement savings plan or other registered plan, as well as employee stock options. If the employee stock options are exercised while the employee is resident in the foreign country, the employee will need to determine the extent to which any benefit realized on the exercise of the options is subject to Canadian tax because the benefit is attributed to employment in Canada, and the issuer of the stock options will need to determine any applicable payroll deductions in both countries.

In situations where the Canadian employer has requested that the Canadian employee relocate to a foreign country, it is common for the Canadian employer to enter into a tax equalization or tax protection agreement with the Canadian employee. Generally, such agreements are intended to ensure that the employee does not pay higher additional taxes — Canadian income tax upon departure and foreign tax during the assignment — than the employee would have paid had they not left Canada. In other words, the agreement seeks to make the employee whole to reflect that the assignment was at the request (and presumably primarily to the benefit) of the employer, not the employee. Tax equalization agreements may require the employee to reimburse the employer if their taxes are lower than if they had not moved, while tax protection agreements only protect employees from increased tax costs without imposing an obligation for decreased tax costs. Employers may also offer to cover certain relocation expenses and potentially increased cost of living expenses. Any payments to employees may be considered taxable employment benefits to the employee, requiring a gross-up to make the employee "whole." Such expenses should generally be deductible to the employer.

## CONCLUSION

There are many good business reasons for employers to allow or encourage cross-border remote work arrangements; however, potential tax issues must be carefully considered as part of the cost-benefit analysis of the arrangement. Each situation will differ depending on the facts at issue — particularly the role of the employee — making it crucial for employers to

[6] *See* Diplomatic Note no. JLAB-0112, *Protocol Amending the Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital: Annex B*.


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pay close attention and engage experienced tax advisors in both jurisdictions. In many cases, employers will have to devote resources on an ongoing basis to ensure full and substantive compliance with any guidelines established to manage any risks arising from the arrangement. Although the issues can seem numerous and challenging, they are generally manageable with some forethought, planning and proper implementation.


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