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International Mobility of Highly Skilled Workers in the Canadian Context: Tax Barriers and Reform Options

Jinyan Li
Osgoode Hall Law School of York University, JLi@osgoode.yorku.ca

Skills Research Initiative
Initiative de recherche sur les compétences

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Courriel : mepa.apme@ic.gc.ca

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Abstract

This paper discusses the tax implications for highly skilled workers who move across borders. This paper uses Canada, the United States and China as case studies to demonstrate the extent to which barriers to labour mobility exist. It argues that cross-border tax and pension issues are not only important to the mobile workers, but also to their employers (especially in the case of intra-company transfers) and the government. Policy recommendations are made on how such barriers can be removed or reduced. These recommendations are guided by the principles of efficiency and equity, and are influenced by the global perspective that views international labour mobility as "brain circulation" as opposed to "brain drain" or "brain gain". Although the paper briefly discusses the pros and cons of adopting a "pro-active" tax policy to attract inbound mobile workers, it does not recommend it as a general policy. In addition to policy recommendations, this paper also suggests specific reform measures that can be unilaterally taken as well as in the bilateral treaty negotiations in order to ensure that highly skilled workers move into and out of Canada without undue tax barriers.

Résumé

Cette étude porte sur les conséquences fiscales pour les travailleurs hautement qualifiés qui déménagent outre-frontière. L'auteur se sert du Canada, des États-Unis et de la Chine comme études de cas pour évaluer l'ampleur des obstacles à la mobilité de la main-d'œuvre. Il soutient que les questions relatives aux pensions et à la fiscalité entre les frontières sont importantes non seulement pour les travailleurs sans attaches, mais aussi pour leurs employeurs (surtout dans le cas des mutations au sein de la même société) et pour le gouvernement. Il recommande des politiques visant à lever ou à atténuer ces obstacles. Ces recommandations, qui reposent sur les principes de l'efficience et de l'équité, sont envisagées dans une perspective globale selon laquelle la mobilité internationale de la main-d'œuvre constitue une « circulation des cerveaux » plutôt qu'un « exode des cerveaux » ou un « recrutement des cerveaux ». Bien que l'auteur parle brièvement des avantages et des inconvénients d'une politique fiscale proactive destinée à attirer des travailleurs sans attaches, il ne recommande pas d'en faire une politique d'application générale. Outre les politiques recommandées, l'auteur propose des réformes précises qui peuvent être faites unilatéralement ou dans le cadre de négociations de traités bilatéraux afin de veiller à ce que les travailleurs hautement qualifiés ne soient pas confrontés à des obstacles fiscaux indus à leur arrivée au Canada ou à leur départ du Canada.

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1. INTRODUCTION

This study investigates the issues of taxation that impede the international mobility of highly skilled workers (HSWs). Mobility of HSWs is important to Canada's goal to "develop the most skilled and talented labour force in the world."[1] Building a more innovative Canadian economy requires a labour force of sufficient size with the right mix of skills. However, for an open and relatively small country like Canada, the supply of the labour force presumably depends on the inflows of HSWs from other countries and the retention of Canadian HSWs. International mobility of HSWs thus affects Canada's ability to compete successfully in the global economy. Furthermore, Canada has committed to the principle of free trade in services under the General Agreement on Trade in Services (GATS) and to "facilitate the cross-border movement of … services" under the North American Free Trade Agreement (NAFTA).

Several empirical studies[2] find tax policy as a relevant factor to the mobility of international expatriates and their employers. There is also considerable evidence that the relative taxation of HSWs has an impact on where multinational investors decide to invest.[3] This is because the employer typically assumes the total gross labour costs (including compensation, personal income taxes and similar charges) in the case of intra-company transfers. It is also important that Canadian businesses get the international recruits they need at the best price. The skills needed to produce growth and innovation are in demand internationally. If tax obstacles deter international HSWs from coming to Canada, Canadian businesses have to increase the level of compensation in order to explicitly or implicitly offset the tax obstacle. If foreign HSWs are deterred from

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[1] Industry Canada, *Achieving Excellence*, (Ottawa: Industry Canada, 2002).

[2] For example, Sandra Lopes, "Canadian Business Perspectives on the International Mobility of Skilled Workers" online: Public Policy Forum <www.ppforum.ca>; PricewaterhouseCoopers, "Managing Mobility Matters – a European Perspective" (2002), online: PriceWaterhouseCoopers <www.pwcglobal.com/ie/eng/ins-sol/spec-int/globalhr/pwc_mobilityfeb02.pdf> [hereinafter "PWC 2002"]; and PricewaterhouseCoopers, "International Taxation of Expatriates: Survey of 20 Tax and Social Security Regimes and Analysis of Effective Tax Burdens on International Assignments" (2005) (for the executive summary of this report, see <http://www.pwc.com/de/ger/about/press-rm/Executive_Summary.pdf>. [hereinafter "PWC 2005"]. Tax policy was considered relevant by others as well: see Richard Harris, "Labour Mobility and the Global Competition for Skills: Dilemmas and Issues" (Ottawa: Industry Canada, Micro-Economic Policy and Analysis, 2004); Sami Mahroum, "Highly Skilled Globetrotters: The International Migration of Human Capital" (1999), online: OECD <www.oecd.org/dataoecd/35/6/2100652.pdf> (In addition to immigration legislation, other factors, such as taxation … play an important role in the choice of highly skilled migrants to relocate overseas); and OECD, Developing Highly Skilled Workers: Review of Canada (2004) (noting at p.16 the tax incentives provided by the Quebec government to new immigrant researchers or expert) (hereinafter "OECD 2004").

[3] PWC 2005, ibid.

taking a job in Canada entirely, Canadian businesses may then have to accept a second-best candidate, with an ongoing cost to the efficiency of the business. Taxation has also been identified by the Organization for Economic Co-operation and Development (OECD) as potential barriers to cross-border labour mobility.[4] The OECD has recently recommended measures for preventing double taxation and non-taxation of mobile workers in respect of employee stock options and pensions.[5] The OECD notes:[6]

> The globalization of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reason. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. As these issues often affect large number of individuals, it is desirable to address them in tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.

This paper contends that taxation is a significant impediment to international mobility of HSWs. Generally speaking, international mobility of workers is part and parcel of the globalization process and globalization creates problems to nation-based tax laws. Since the early 1920s, the world community has worked together to remove tax barriers to international trade and investment.[7] Until recently, the field of individual taxation was mostly treated as a purely domestic matter because individuals were less mobile than companies. As a result, current national individual income tax laws vary significantly, resulting in either gaps or overlaps in the taxation of mobile HSWs. The overlaps between national tax laws lead to double taxation, while

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4 International Fiscal Association IFA has published report on the tax treatment of the transfer of residence by individuals and deferred compensation for cross-border employees. See IFA, "The Tax Treatment of Transfer of Residence by Individuals" (2002) LXXXVIIb *Cashiers Dr. Fisc. Int'l*, and "International Tax Aspects of Deferred Remunerations" (2000) LXXXVb *Cashiers Dr. Fisc. Int'l*.

5 OECD Discussion Draft, "Tax Treaties Issues Arising from Cross-Border Pensions (2003)" online: OECD < http://www.oecd.org/dataoecd/24/40/19239649.pdf>. See also OECD, OECD Recommends Common Tax-Treaty Approaches to Employee Stock-Options (9 March 2004), online: <http://www.oecd.org/document/31/0,2340,en_2649_201185_33700026_1_1_1_1,00.html>.

6 OECD Commentary on the Model Convention (2005) (OECD, Paris), at para.8 of the Commentary on Article 18.

7 Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), at 34-49.

the gaps lead to tax avoidance or evasion.[8] The objectives of this research are to examine whether – and, if so, how – specific kinds of Canadian tax (and related pension) policies hinder the international mobility of HSWs, and to explore the extent to which Canadian tax policies can be adjusted such that it is neutral or enhancing to mobility.

This paper adopts an analytical and theoretical approach to the treatment of the issues. It relies mainly on empirical research as reported in the secondary literature in assessing the current state of international mobility of HSWs, and potential obstacles to such mobility. The analytical approach is comparative by studying the case of Canada, the United States and China. The United States is selected for the obvious reason that it is the most important trading partner of Canada and the largest recipient of outbound Canadian HSWs. China is selected because it is becoming a significant trading partner and is one of the significant sources of inbound HSWs. Through this comparative study, this paper demonstrates that tax barriers arise not only because of Canadian domestic tax policies, but also due to the overlaps or gaps in tax policies of Canada and the other countries. Similarly, the removal of tax barriers to cross-border mobility of HSWs will depend on the effective bilateral coordination of tax policies.

The structure of the paper is as follows. Following the introduction in Part 1, Part 2 provides the contextual background on international mobility of HSWs. This part overviews the literature on international mobility of HSWs in terms of the recent trends, the drivers and barriers, changing perspectives, and the relevance of taxation and pension issues. Part 3 to Part 4 discuss the current tax and pension issues in respect of international mobile workers under the domestic law and bilateral tax treaties, including the tax consequences of giving up or acquiring Canadian tax residency, the treatment of cross-border employee stock options, contributions to pension plans and benefits received from pension plans. Part 5 summarizes the tax and pension implications for outbound (coming to Canada) or inbound (leaving Canada) HSWs. Part 6 and Part 7 draw some policy conclusions and make several recommendations. The main conclusion is that Canadian tax policies were designed for the "traditional" permanent migration model of labour mobility and, as a result, have created barriers to international mobility of skilled workers.

[8] *The Economist* put it succinctly that "globalization … nibbles away at the edges of taxes on individuals. It is harder to tax personal income because skilled professional workers are more mobile than they were two decades ago." See *The Economist* (31 May, 1994), at 23.

It recommends a number of changes to be made to domestic law and tax treaties. The paper discusses the possible unilateral changes to the tax rates and the computation of employment income in respect of employee stock options and pension plans. It also discusses the pros and cons of introducing tax incentives to mobile HSWs. In terms of treaty policy reform, Part 7 suggests that changes to the Canada-United States Tax Treaty[9] and other treaties to better "coordinate" or "integrate" Canadian tax laws and the laws of the other country.

[9] *Convention Between Canada and the United States of America with respect to Taxes on Income and on Capital,* 26 September 1980 , CTS 1984/15 [hereinafter Canada-US Treaty]. See also Amending Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997.

2. INTERNATIONAL MOBILITY OF HIGHLY SKILLED WORKERS

2.1 "Highly Skilled Workers" (HSWs)

The term "highly skilled workers" does not have an international or global definition. This paper adopts the following definition: "Skilled workers" are "those individuals who are engaged in knowledge-intensive professions such as physicians, nurses, science and technology (S&T) workers, engineers, information technology (IT) specialists, graduate and post-doctoral students, scholars and researchers, and administrators and managers."[10] HSWs are generally highly-educated and arguably have high productivity.[11]

Because knowledge and skills are key to the information-based, globalizing economy, the recent globalization appears to have been accompanied by an increase in the movement of HSWs. Skilled workers are one of, if not the most, important internationally mobile resources.[12] As Lopes explains:[13]

> The rising intensity of production in all industries, especially in manufacturing and services, has led to a growing premium being paid to these workers. Business and governments are competing for highly skilled labour in a global market. In response to the demand for their skills, workers themselves are increasingly mobile – willing to move internationally and recognizing international assignments as an important part of their professional development.

The available data show that the migration of skilled workers, especially from China and other Asian countries to major OECD countries, rose substantially during the 1990s.[14] International

[10] S. Gera, S.A.Laryea, & T. Songsakul, "International Mobility of Skilled Labour: Analytical and Empirical Issues, and Research Priorities" (Ottawa: Government of Canada, 2004) at 7.
[11] Assaf Razin & E. Sadka, "Capital Income Taxation in the Globalized World" (2004) Online: NBER http://www.nber.org/papers/w10630 at 3.
[12] Harris, supra note 2; K. Head & J. Ries, "Can Small-Country Manufacturing Survive Trade Liberalization?: Evidence from the Canada-U.S. Free Trade Agreement" (Ottawa: Industry Canada, 1999).
[13] Lopes, supra note 2, at 5-6.
[14] OECD, International Mobility of the Highly Skilled (Paris, OECD 2002).

mobility of skilled workers is increasingly important to businesses as they adopt global strategies in locating their research and development, production, and marketing activities.[15]

Canada has been a sending country as well as a receiving country for HSWs. Canada is a major recipient of skilled workers from the rest of the world: China has been the leading source country of immigrants, whereas the United States, Mexico and the United Kingdom are the main source countries for temporary skilled labour. Canada is also the main source country for foreign HSWs in the United States.[16]

2.2 Forms and Trends of Mobility

Gera, Laryea and Songsakul identify four forms of mobility: (1) the "traditional" permanent migration – where HSWs move on a permanent basis from one country to another; (2) temporary skilled migration – such as admissions to the United States based on H-1B visa or TN visa; (3) intra-company transferees – which are generally associated with multinational enterprises; and (4) temporary visiting foreign scholars and researchers.[17] Temporary skilled migration and intra-company transferees seem to have been increasing in recent years. For example, intra-company transferees in the United States virtually tripled in magnitude between 1995 and 2002.[18] According to Citizenship and Immigration Canada, permanent skilled immigrants to Canada increased from 80,823 in 1995 to 113,442 in 2004, and inflow of temporary workers was increased from 69,725 in 1995 to 90,668 in 2004.[19]

Researchers have identified some recent trends in international mobility of HSWs. For example, the increase in skilled migration among OECD countries was characterized by temporary inflows as opposed to permanent inflows.[20] In other words, instead of permanent migration, skilled workers are moving across countries for a short period of time. There is also

[15] PWC (2002), supra note 2; PWC 2005, supra note 2.
[16] Gera, Laryea & Songsakul, supra note 10.
[17] Ibid., at 8.
[18] Ibid.
[19] Canada, Citizenship and Immigration, "Facts and Figures: Immigration Overview – permanent and temporary residents" (Ottawa: 2004), at 2 and 62-3.
[20] D. Guellec & M. Cervantes (2001) "International Mobility of Highly Skilled Workers: From Statistical Analysis to Policy Formation". In: International Mobility of the Highly Skilled. (OECD, Paris 2002: 71-99).

growing evidence of outflows of skilled workers from the OECD countries to Asia,[21] which may signal substantial return migration to Asia. In India and China, for example, the emerging high-tech industry and rapid economic growth have led to the return migration by citizens who had moved to Western countries as students and young professionals, but who now see career and entrepreneurial opportunities in their countries of birth. Research data shows that these return migrants are well-educated, bi-lingual, professional, in the early stage of their career and have considerable earnings capacity.[22]

Traditionally, several factors motivated people to migrate from one country to another.[23] These include: better job opportunities, political and social conditions, post-graduate education, etc. The driving forces behind the recent trends include technological changes, globalization of production and integration of markets through trade in goods and services and foreign direct investment, location of multinational enterprises, technology transfer and the internationalization of research and development activities of national firms.[24] Differences in labour market conditions and increased income and employment opportunities are also relevant factors.[25] With respect to intra-company transfers, the global competition for market share requires corporations to send their employees to foreign countries to implement or deliver product solutions, sell products, or otherwise generate revenue. Restructuring of global businesses is another factor. The current economic climate has changed the way in which many corporations use foreign assignments as part of their business strategy. Most corporations have significantly scaled back

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[21] OECD, *International Mobility of Science and Technology Personnel,* (OECD 2002).

[22] David Ley & Audrey Kobayashi, "Back in Hong Kong: Return Migration or Transnational Sojourn?" (April 2005) (Vancouver Centre of Excellence, Research on Immigration and Integration in the Metropolis, Working Paper Series, No.05-09). This phenomenon may require an adjustment to the four-fold scheme suggested by Gera et al to the extent the return-migration phenomenon may represent a certain provisional nature for migration that began with expectations of permanence and turns out to have been temporary.

[23] For a survey of the literature, see Benoit Dostie and Pierre Thomas Leger, "A Critical Review of the Microeconomic Migration Literature" (Working Paper 2004 D-05).

[24] Gera, Laryea & Songsakul, supra note 10; S. Globerman, "Perspectives on North American Free Trade: Trade Liberalisation and the Migration of Skilled Workers", (Ottawa: Industry Canada, 1999) Online: <http://strategis.ic.gc.ca/epic/internet/ineas-aes.nsf/vwapj/P3-an.pdf/$FILE/P3-an.pdf>; and S. Mahroum, "Highly Skilled Globetrotters: The International Migration of Human Capital" (1999) online: OECD http://www.oecd.org/dataoecd/35/6/2100652.pdf > .

[25] Gera, Laryea & Songsakul, supra note 10.

the once-lucrative mid- to longer-term packages offered to their employees, and the trend in the industry has been to consider short-term assignments as an alternative.[26]

2.3 "Brain Drain" versus "Brain Circulation" Perspectives

The literature on migration indicates a change in the perspective on mobility. The traditional migration literature treats labour as fairly homogeneous and the net out-migration of skilled workers as a "brain drain".[27] There are a number of studies indicating the existence of brain drain from Canada to the United States.[28] Some suggest that the brain drain is not significant throughout most of the 1990s, and thus not a serious concern;[29] others suggest that there is a much greater cause for concern.[30]

More recent literature on mobility establishes a new global economic perspective.[31] International mobility of skilled labour is considered as a "brain exchange", "brain circulation" or the "globalization of highly skilled labour market".[32] It suggests two-way flows of knowledge, ideas and technology among trading countries. Proponents of this perspective maintain that the international mobility of HSWs can generate global benefits by improving knowledge flows and satisfying the demand for HSWs where that demand is the strongest. Contrary to the zero-sum game theory under the brain drain perspective, the new global economy perspective suggests that "greater skilled-labour mobility may well lead to better long-term economic outcomes among the

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[26] Lopes, supra note 2; Bruce Sprague & Michael Hayward, "The Taxation of US Employees in Canada" (2004) 52 *Can. Tax J.* 192, at 192.
[27] Gera, Laryea & Songsakul, supra note 10, at 22.
[28] See for example, R. W. Boadway & H.M. Kitchen, "Personal Income Tax Reform in a Broader Context" (1998) 47 *Can. Tax. J.* 566; OECD 2004, supra note 2 (noting at p.17 that a significant number of Canadians with Masters and Doctorates in science and engineering fields migrated to the United States and Canada is the second largest source of foreign HSWs in the United States in 1999).
[29] Finnie, R., "The Brain Drain: Myth and Reality - What It is and What Should be done," (2001) 7:6 *Choices* 3.
[30] M. Iqbal, "Brain Drain: Empirical Evidence of Emigration of Canadian Professionals to the United States" (2000) 48 *Can. Tax J.* 674; D. Schwanen, Putting the Brain Drain in Context: Canada and Global Competition for Scientists and Engineers, Commentary no.140 (Toronto: C.D. Howe Institute, 2000) ; D. DeVoretz, & S.A.Laryea, Canadian Human Capital Transfers: The United States and Beyond, C.D. Howe Institute Commentary no.115 (Toronto: C.D. Howe Institute, 1998).
[31] Gera, Laryea & Songsakul, supra note 10, at 5.
[32] Ibid.

countries participating in that labour exchange."[33] For example, the OECD estimates that 15 percent of high-income earning Canadian migrants in the United States return to Canada after 5 years and 20 percent return after 10 years, and that such mobility of HSWs could improve knowledge flows and spillovers.[34] The brain circulation perspective is consistent with the economic theory underlying international free trade and economic globalization.

The Canadian situation seems to support the brain circulation model: there is a brain drain to the United States, and a brain gain from the rest of the world. Overall, Canada is a net importer of highly educated individuals.[35] Temporary migration (both inbound and outbound) is becoming more important and return migration is on the rise.[36] The return-migration phenomenon may be significant from a policy perspective to the extent that it involves a bilateral variation on the global brain-circulation thesis.

2.4 Research on Taxation and Mobility

Canadian literature on tax policies and the mobility of labour has been dominated by the issue of brain drain to the United States. Some studies suggest that differing tax rates may be a primary reason for the "best" and the "brightest" Canadians to move south,[37] while others suggest otherwise. In a recent empirical study, Wagner[38] found that income and tax were positively correlated to the migration decision, but the responsiveness to taxation levels is quite small: lower Canadian taxes would decrease the southward flow of Canadians, but not by much. He suggests that even if the income opportunities and taxes in both countries were *identical,* 59 per cent of people who moved south would have moved south in any event. Nevertheless, stemming the brain drain to the United States was cited as a major justification for introducing the tax incentives on employee stock options and capital gains, and for the lowering of Canadian tax

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[33] Ibid, citing R. Harris & N. Schmitt, 2003, "The Consequences of Increased Labour Mobility within an Integrating North America" in R. Harris, ed., North American Linkages: Opportunities and Challenges for Canada (Calgary: University of Calgary Press, 2003); Harris, supra note 2.

[34] OECD 2004, supra note 2, at 17.

[35] J. Zhao, D. Drew, & T. S. Murray, 2000, "Brain Drain and Brain Gain: The Migration of Knowledge Workers from and to Canada" (2000) 6 *Education Quarterly Rev*. 8.

[36] Gera, Laryea and Songsakul, supra note 10.

[37] Iqbal, supra note 30; S. Nadeau, L. Whewell & S. Williamson, "Beyond the Headlines on the 'Brain Drain'" (2000) 1 *ISUMA* 154 .

[38] D. Wagner, "Do Tax Differences Cause the Brain Drain?" (2000) 21 Policy Options 33.

rates.[39] It may have also influenced the introduction of the "departure tax" (see below). Some scholars recognize the revenue loss and serious sovereignty implications.[40] Helliwell suggests that "at least for the personal income tax, Canadian policy should be focused on what is best for Canada and Canadians; presumed migration pressures should not force it to follow whatever the US Congress generates".[41]

More recent literature on international mobility of HSWs finds that taxation is a potential barrier to mobility. A study by PricewaterhouseCoopers (2002)[42] surveyed 400 businesses in eight European countries; 10,000 individuals in ten European countries; and conducted a series of case studies on 25 multinational corporations. The key policy-related barriers to mobility include differences in tax systems, benefit systems and pension systems between member states. A subsequent PricewaterhouseCoopers study (2005)[43] finds that the most important tax is income tax on employment income and that within this tax system both the rates and base (inclusions and deductions in computing taxable income) are relevant. The taxation of special forms of compensation, such as employee stock options, is also important. Interestingly, the study also reveals that a major obstacle for international assignment is the possibility of double taxation on pensions from occupational pension schemes.

A Canadian study by Lopes[44] finds that labour cost is a primary obstacle to intra-company transfers. The most significant cost-related obstacles include employee compensation, the exchange rate and taxation. With respect to taxation, tax rate is a pertinent factor:

> Taxation is an impediment to labour mobility when moving people from countries with lower taxation rates to countries with higher rates. To make the transfer attractive, the company must compensate the employee for the difference, increasing the cost of the transfer. Taxable benefits, for example accommodation allowances, also increase mobility costs.

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[39] N. Brooks, "Flattening the Claims of the Flat Taxers" (1998) 21 no.2 *Dalhousie L. J.* 287; D. Sandler, "The Tax Treatment of Employee Stock Options: Generous to a Fault" (2001) 49 *Can. Tax J.* 259.
[40] Sandler, ibid.; Brooks, ibid.
[41] John Helliwell, "Brainstorming", (2001) *Choices*, 7(6): 46-9.
[42] PWC 2002, supra note 2.
[43] PWC 2005, supra note 2.
[44] Lopes, supra note 2.

Existing literature on taxation and labour mobility has not adequately addressed specific Canadian tax and pension issues. Legal tax scholars have not contributed to the literature in this area. The next three parts of this paper aim at remedying a portion of this gap.

3. INCOME TAX ISSUES

3.1 Overview

The Canadian international income tax system is very complex. Highly skilled workers who move to Canada or move away from Canada are exposed to many aspects of the tax system. It is beyond the scope of this paper to fully discuss this complex subject matter. What follows is an examination of the key issues affecting the tax treatment of mobile workers when a HSW moves between Canada and the United States or between Canada and China.

3.1.1 Canadian tax system

The Canadian income tax treatment of internationally mobile workers is governed by domestic law and bilateral tax treaties. The primary sources of domestic law are the Income Tax Act (the "ITA"),[45] Income Tax Regulations,[46] and case law that interpret the provisions of the tax legislation. Canada has concluded a bilateral tax treaty with over 80 countries, including the United States and China. All of these treaties are based on the OECD Model Convention,[47] and, to a lesser extent, the UN Model Convention.[48] A tax treaty is a part of Canadian income tax law. In the case of any inconsistency between the provisions of domestic law and the provisions of a treaty, the latter will prevail.

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[45] R.S.C. 1985, (5th supp.), c. 1 [hereinafter the "ITA"].
[46] C.R.C., c. 945.
[47] *OECD Model Double Taxation Convention on Income and on Capital*, Paris, 1977, revised in 1992, 1995 and 2000 [hereinafter the "OECD Model"].
[48] *United Nations Model Double Taxation Convention between Developed and Developing Countries*, UN, ST/ESA/102 (1980). [hereinafter the "UN Model"].

The primary objective of Canadian income tax law is to raise revenue in a fair and equitable manner. The ITA is often used to reach the goals of redistributing of social income and regulating the economy by encouraging or discouraging certain activities.[49]

The major determinant of an individual's Canadian liability is his/her residence status. The ITA provides that every person resident in Canada, at any time in the year, is liable to Canadian tax on his/her worldwide income (i.e., residence-based taxation). These individuals must file an income tax return and pay taxes. Taxes on employment income are withheld by the employer. The harshness of taxing income from non-Canadian sources, which may have already been taxed in the foreign country of source, is mitigated by deducting the foreign tax as a credit against Canadian tax. Non-residents of Canada are taxed only on Canadian-source income (i.e., source-based taxation). For example, non-resident individuals earning employment income in Canada or business income from providing personal services as independent contractors are taxed on such income. Income from investment (such as dividends, interest, rent and royalties) and benefit payments from Canadian pension plans are subject to Canadian withholding tax at the rate of 25 percent (which is often reduced by tax treaties).

Canadian residents and non-residents earning Canadian-source employment income, certain capital gains, and business income are subject to tax at progressive rates. The federal rates range from 16 to 29 per cent, and provincial rates are imposed on federal tax base, resulting in combined rate of about 40 to 45 percent.

3.1.2 US Tax System

The United States imposes income taxes pursuant to the *Internal Revenue Code* on the basis of residence and citizenship of taxpayers, as well as the source of income. The notion of "income" is defined broadly to include all accessions to wealth with a few well-defined exclusions. Significant exclusions include gifts, bequests, and proceeds from life insurance policies. Income is recognized upon the occurrence of a realization event (such as a sale). Like Canada, the United States has an extensive network of bilateral tax treaties.

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[49] P. Hogg, J. Magee & J. Li, *Principles of Canadian Income Tax Law*, 5h ed. (Toronto: Carswell, 2005), ch.1.

Unlike Canada, the US asserts the right to tax the worldwide income of not only its residents but also its citizens. Indeed, citizenship is the primary basis under the Code for exercising residence jurisdiction over individuals. To reduce double taxation, the US grants a foreign tax credit to US citizens and residents for income taxes paid to foreign governments with respect to foreign source income. Foreign persons are subject to US source taxation. The Code contains extensive source rules to determine what constitutes US sources. The United States uses two quite different regimes to tax non-residents. One regime imposes a 30 per cent tax on the gross amount of specified types of US source passive income (including pension benefit payments). The second regime applies regular US tax rates to the net income effectively connected with a US trade or business.

Individual tax rates range from 10 to 36 per cent. Joint filing is allowed between spouses. Some states and cities also impose local income tax. State income tax rate ranges from 0 per cent up to 12 per cent and city or municipal tax rate is generally about 1 percent. The top combined rate in the United States is about 44 per cent.[50]

3.1.3 Chinese Tax System

China imposes individual income taxes under the Individual Income Tax Law[51] on both Chinese and foreign nationals. Unlike the individual income taxes in Canada and the United States, the Chinese tax is a schedular tax – different types of income attract different tax liabilities and there is no integration between different sources of income. There are eleven categories of taxable income. Each category is computed and taxed separately. While employment income is taxed at progressive rates (up to 45%), other types of income are generally taxed at a flat rate of 20%. There are no provincial or local individual income taxes.

Chinese citizens living in China are liable to tax on a worldwide basis of income, and so are foreigners who reside in China for one year or more. However, most foreigners are eligible for an

[50] PWC 2005, supra note 2, at 25.
[51] Law of the People's Republic of China Concerning Individual Income Tax, promulgated by the National People's Congress on September 10, 1980, amended in 1993 and 2005.

exemption on non-Chinese source income and, as a result, pay Chinese tax only on Chinese source income. Foreigners who never visit China or stay in China for less than one year are liable to Chinese tax only on their Chinese source income. Certain Chinese source income is exempt from tax. For example, certain Chinese source employment income derived by foreign individuals who reside in China for 90 days or less during a year is exempt from tax. Non-resident individuals are subject to a withholding tax on their investment income at 20 per cent, although this tax is generally reduced or waived under a tax treaty.

China has a treaty with Canada, the United States and many other countries. In its treaties with OECD countries, China has taken the position of a developing country and has insisted on a rather broad scope of source jurisdiction. For example, China's treaties generally have relatively high rates of withholding tax on dividends, interest, and royalties.

Table 1: Income Tax Rates in Canada, US and China

Country	Top personal tax rate (combined)	Income on which the top personal tax rate applies
Canada	40-47% (provincial rates vary)	CND100,000
US	44.3%	USD319,000 (CND370,040)
China	45%	CNY1,200,000 (CND176,470)

3.2 Canadian Residence

3.2.1 Definition of "residence"

Residence is the principal connecting factor used for Canadian income tax purposes. It emphasizes the social and economic connections between a person and the taxing jurisdiction. Whether a person is a resident in Canada is based on the facts and circumstances of each case. The Courts have held "residence" to be "a matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question."[52] The common law has established that several factors are important in determining whether an individual is resident in Canada but none are conclusive. These factors include:

- The maintenance of a dwelling in Canada available for occupation by the taxpayer. This is generally the most significant factor in determining whether a taxpayer has ceased to be a resident of Canada.
- The fact that the taxpayer's spouse and children are residents of Canada.
- The taxpayer's ties to another country.
- The taxpayer's social and economic ties with Canada (including ownership of property (e.g., furniture, clothing, automobile, bank accounts, credit cards, etc., club memberships, family, medical insurance coverage in Canada, and professional or other memberships in Canada).
- Other factors, such as the taxpayer's intention to return to Canada and the failure to pay tax or file tax returns in a foreign country.

The ITA also contains two deeming rules. Section 250(3) includes a person who was at the relevant time ordinarily resident in Canada as a resident in Canada. This rule reinforces the proposition that a temporary absence from Canada, even one lasting for the full taxation year in issue, does not necessarily involve a loss of Canadian residence. If a family household remains in Canada, or possibly even if close personal and business ties are maintained in Canada, then the taxpayer may be held to be "ordinarily resident" in Canada. S.250(1)) deems a person as a resident in Canada throughout the year if he/she sojourned in Canada in the year for a period of, or periods the total of which is, "183 days or more." The term "sojourner" is typically a resident of another country and comes to Canada on a vacation or business trip. In most cases, of course, a sojourner would stay in Canada for only a short period of time, but if the sojourner stays for a period of 183 days, or for several periods totaling 183 days, then the effect of s.250(1)(a) is to tax the sojourner as if he or she were a resident for the whole year.

[52] Canada Revenue Agency, Interpretation Bulletin IT-221R3, "Determination of an individual's residence status" (October 4, 2002) at para. 2.

3.2.2 Tax consequences of change in residence

There are significant Canadian tax consequences when an individual acquires or abandons his/her Canadian residency. One is the taxation of income earned outside Canada. Another is the taxation of capital gains from properties owned by the taxpayer.

Under the ITA, non-Canadian income is not taxable in Canada if it is earned by a Canadian non-resident person. Therefore, it is important to determine when Canadian residence is obtained or abandoned and the taxpayer is liable for Canadian tax on his/her worldwide income for part of the year during which he/she is a Canadian resident (s.114). For example, an individual who becomes a resident in Canada on July 1, 2005 will be taxable in Canada on his/her foreign income earned from July to December of 2005. Any foreign income earned prior to July 1 is tax-free in Canada.

The change in residence of an individual also triggers a deemed disposition of each property owned by the individual. When an individual changes his/her residence status, s.128.1 of the ITA deems a sale of all properties owned by the taxpayer immediately before acquiring or abandoning Canadian residency. Because this rule results in actual tax liabilities for departing Canadians, it is known as the "departure tax". The basic purpose of s.128.1 is to ensure that a migrating taxpayer is subject to tax in Canada only in respect of gains and other income that accrue while the taxpayer is resident in Canada. Excluded from this basic rule are properties whose gains will be taxable in Canada to the non-resident and are not likely to be treaty protect. For emigrants, excluded properties include real property situated in Canada, employment-related stock options and certain pension and similar rights (s.128.1(10) of the ITA). The technique employed by section 128.1(4) is to deem a taxpayer who has ceased to be a Canadian resident to have disposed of most property at fair market value immediately before departing from Canada and to have reacquired the same property at a cost equal to the fair market value.

For example, X is an individual who moved to the United States from Canada and became a non-resident on July 1, 2005. At that time, X owned a house in Canada with a cost of $200,000 and fair market value on the date of departure of $260,000, and shares of a public company with a cost of \$80,000 and fair market value of \$90,000. X is deemed to have sold the shares for \$90,000 and reacquired the same shares at a cost equal to \$90,000. The \$10,000 capital gain must be included in computing his/her income for 2005. The \$10,000 is a "paper" gain only because the taxpayer still owned the shares after leaving Canada. If X sells the shares for \$110,000 in 2006 while living in the US, the \$20,000 gain accrued after the departure from Canada is not taxable in Canada. The house is excluded from the deemed disposition rule. When the house is actually sold by the taxpayer after becoming a non-resident, the gain will be taxable in Canada (s.2(3)(c) of the ITA). If the house is a principal residence, the portion of gain attributable to the year of Canadian residence is exempted from tax (s.40(2)(b) of the ITA).

3.2.3 Implications for Canadian Workers Leaving Canada

For Canadian HSWs working in foreign countries, several potential issues arise. One issue is the uncertainty in determining Canadian residence status. The common-law fact-based tests are uncertain sometimes and reach different conclusions in similar factual situations.[53] For a Canadian worker moving temporarily to another country, he/she may still be considered to be "ordinarily resident" in Canada during the entire period of the physical absence from Canada. In *Gaudreau v. R.*[54] for example, the taxpayer was a Canadian citizen and left Canada in September 1996 to work for his Canadian employer in Egypt. Under his employment contract, the employer paid for his air transportation to Egypt, return trip to Canada after 12 months and home location at the end of contract. The taxpayer maintained two Canadian bank accounts with his pay deposited into one Canadian bank account, maintained RRSP, credit cards and safety deposit box in Canada, and kept his Canadian passport. He and his wife leased an apartment in Egypt on yearly basis but maintained their home in Canada. He arranged for someone to look after Canadian house regularly with all household bills paid from his Canadian bank account. The taxpayer did not have any social life in Egypt because he was working almost seven days a week with all spare time spent with his wife. He returned to Canada in April 2000 when his

[53] For a discussion of recent cases, see Arnold Sherman, "Canadian Residents Leaving Canada – Recent Jurisprudence" (2005) vol. 59, No.7 *Bulletin for International Fiscal Documentation* 290-94.

[54] 2005 D.T.C. 66, [2005] 1 C.T.C. 2701 (T.C.C), upheld by the Fed. C.A. 2005 D.T.C. 5702 (Eng.), [2006] 1 C.T.C. 137.

employment contract was completed. The taxpayer was held to be ordinarily resident in Canada from 1996 to April 2000.

In the meantime, an outbound Canadian worker such as Mr. Gaudreau, may be found to be a resident in the foreign host country as well. This dual residency problem can only be addressed by the tie-breaker rules in a tax treaty. In Mr. Gaudreau's case, the tier-breakers confirmed his Canadian residence. In other cases, the tie-breakers help the taxpayer claim non-residence status in Canada. In *Allchin v. R*[55] the taxpayer worked in the United States from 1992 to 1997. During this period she stayed with relatives and friends while her husband and two children lived in Canada. She also set up a U.S. bank account, arranged for her credit card bills to be sent to a U.S. address and attempted to move her family to the U.S. by retaining the services of an immigration lawyer. The Tax Court concluded that the taxpayer remained a Canadian resident during the years 1993 to 1995 because of the temporary nature of her accommodation and due to her continuing ties to Canada: her husband and children, her Ontario driver's license, her OHIP (Ontario health insurance) coverage, a club membership, and the fact that her husband swore in an affidavit when he purchased a house that his wife was a resident of Canada. Subsequently, the taxpayer was successful in arguing that she was a resident in the United States under the tie-breaker rules in the Canada-United States tax treaty. The problem remains if the worker comes from a jurisdiction that has no tax treaty with Canada, such as Hong Kong, which is not covered by the Canada-China Tax Treaty.[56]

The second tax issue for outbound HSWs is the departure tax. The taxation of "paper" gains creates two types of potential problems for taxpayer. The first problem is the liquidity problem with respect to paying the tax in Canada. Because the departure tax is imposed on "paper" gains, the taxpayer may not have sufficient cash to pay the tax. The ITA provides some relief. For example, the taxpayer has the option of providing adequate "security" in lieu of tax payment (s.220(4.5) of the ITA). The taxpayer may also elect, upon providing adequate security, that certain capital property owned by the individual not be subject to a deemed disposition. The

[55] 2003 TCC 476, 2003 D.T.C. 935 (T.C.C.).
[56] Canada-China Income Tax Treaty, 12 May 1986. As explained by the Court in Edwards v. R, [2002] 4 C.T.C. 2202, 2002 D.T.C. 1856 (T.C.C.), Hong Kong is not part of "China" for the purpose of the Canada-China Tax Treaty mainly because Hong Kong has its own independent tax system.

second problem is the potential double taxation caused by a mismatch in the Canadian departure tax and the capital gains tax system in the other country. For example, under the domestic tax laws of the United States, the "departure tax" is not recognized as a real tax. So, in the above example, when X sells the shares in 2006 for $110,000, under the US tax rules, the amount of gain is $30,000 ($110,000 - $90,000), $10,000 of which was already taxed by Canada in 2005. Therefore, the $10,000 gain is taxed twice: once in Canada under the departure tax and again in the United States. Relief from such double taxation is possible only through tax treaties. Article XIII of the Canada-US tax treaty provides for relief for potential double taxation by allowing the computation of the US gain to be based on the cost of $90,000. However, such a provision is not included in the Canada-China tax treaty and most of other Canadian treaties.[57] If a HSW moves from Canada to these countries, double taxation still exists.

For short-term residents in Canada (e.g., an immigrant who leaves Canada after a short period of stay), the deemed dispositions rules are triggered twice: once upon becoming a resident and again upon becoming a non-resident. The ITA provides some relief by excluding from the deemed disposition the property owned by the taxpayer when the taxpayer last became resident in Canada or property acquired by inheritance or bequest after the taxpayer last became resident in Canada, provided that during the 10 preceding years the taxpayer was a resident in Canada for no longer than 60 months (s.128.1(4)(b)(v)). For example, taxpayer Y owns a house in Hong Kong and immigrates to Canada in 2005. If she returns to Hong Kong in 2006, the house in Hong Kong is not subject to the departure tax. This exception effectively provides relief for temporary residents of Canada, such as employees of international firms, who migrate to and work in Canada for short periods of time.

3.2.3 Implications for Foreign Workers Coming to Canada

Foreign HSWs coming to work in Canada face significant tax sequences, one of which is the residence issue. If it is determined that the individual is a Canadian resident, he/she is exposed to Canadian taxation on his/her non-Canadian investment income. In addition to being subjected to

[57] Convention Between the Government of Canada and the Government of the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains, 8 September 1978, CTS 1980/25 [hereinafter "Canada-UK Tax Treaty"].

Canadian tax on world-wide income, the Canadian residence status also brings the immigrant within the scope of a highly complex anti-avoidance rules under s.91, s.94 and 94.1 of the ITA. The essence of these rules is to impute offshore passive investment income earned through a controlled foreign corporation, an offshore trust, or investment entity to the Canadian resident. It is beyond the scope of this paper to discuss these rules. It is suffice to state that these rules are highly complex and are designed to prevent Canadian residents from sheltering their offshore income in tax haven entities. HSWs moving to Canada often own investment in their home country and are thus vulnerable under these rules. The immigration trust rules (s.94) provide some relief. Under these rules, an offshore trust is exempted from the anti-avoidance rules where the beneficiary has not been resident in Canada for more than 60 months. However, this relief can be utilized only by those who are well advised.[58]

Another potential tax issue is the continued tax exposure in the “old” country. For an American citizen working in Canada, the United States continues to tax the individual after his/her immigration to Canada. Code s.911 exempts from US income tax for up to $80,000 of his/her Canadian-source earned income. If the old country is China, the individual may also be treated as having a “domicile” in China under the Chinese domestic law and be taxed on his/her worldwide income. In practice, however, the Chinese tax authorities have not enforced this rule vigorously.

Finally, an individual moving to Canada is subject to the deemed disposition and reacquisition rules under s.128.1(1) of the ITA. As a result, any capital gains accrued after becoming a Canadian resident will be taxable in Canada. If the individual is a former Canadian resident and returns to Canada (i.e., an U-turn mobile person), in the absence of special relief provisions, the taxpayer is caught by the deeming rules twice: once at the time of emigration and again at the time of return. A special relief is available under s.128.1(6), which provides that an emigrant who returns to Canada at any time after emigration is not treated as having realized accrued gains on departure. Because there is no certain way of knowing which emigrants will return to Canada, this rule does not directly affect the obligations that arise on emigration. Rather, the rule allows the returning individual to retroactively modify the obligations.

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[58] G. Duncan & E. Peck, *Canadian Resident Abroad* (4th ed.) (Toronto, Ont: Carswell, 2002) at 97.

3.3 Employment Income (General)

3.3.1 Employment versus self-employment

Under both the ITA and tax treaties, the characterization of income is crucial because of the differential regimes designed for each category of income. For example, the scope of deductions for the self-employed (or independent contractors) is much broader than that for employees. The threshold for source taxation under tax treaties is much higher for independent service providers. For independent service providers, the threshold is based on the existence of "fixed base" through which the services are rendered. For dependent service providers (i.e., employees), Canada's tax treaties generally provide an exemption from the employment income earned in Canada if the non-resident individual is in Canada for less than 183 days in a year and the remuneration is not borne by a Canadian resident or by a Canadian permanent establishment of a foreign company. The Canada-US Treaty also provides a lump-sum exemption of up to $10,000.

Overall, both ITA and tax treaties are more accommodating for independent contractors. Non-resident service providers will, thus, invariably prefer to characterize themselves as independent contractors as opposed to employees or artistes or athletes. For example, in *Wolf v. R.* (2002),[59] the taxpayer was an American citizen working in Canada for a Canadian company for five years. The Federal Court of Appeal held that he was self-employed on grounds that he had "financial risk" because the taxpayer had no job security or benefits, and the agreement entered into by the parties indicated their intent to have an independent contractor relationship. Because Mr. Wolf was treated as an independent contractor as opposed to an employee, he was exempt from Canadian tax by virtue of the Canada-US treaty because he did not have a "fixed base" in Canada. The meaning of "fixed base" is interpreted in *Dudney v. R.* (2000),[60] a taxpayer was an aerospace engineer and an expert in object oriented technology. During the relevant taxation year, he lived in Texas, USA, but was hired as independent contractor to work at PanCan on the training of its employees. The work was done on the premises of PanCan in Calgary. The

[59] 2002 FCA 96, 2002 D.T.C. 6853 (FCA).
[60] 2000 D.T.C. 6169, [2000] 2 C.T.C. 56 (Fed. C.A.).

Court found Mr. Dudney to be exempt from Canadian income tax by virtue of the Canada-US Tax Treaty because he did not have a "fixed base" regularly available to him in Canada for the consulting business.

3.3.2 Forms of Employment Income

Employment income generally includes wages, salaries, bonuses, and other forms of remuneration, as well as fringe benefits and stock option benefits (discussed separately below). Tax equalization payments are also included in the employee's income for Canadian tax purposes. Typically, the equalization payment is based on the difference between the tax rates in the home country and the host country. On the other hand, the value of contributions made by an employer to a pension plan is not taxable to the employee.

3.3.3 Cross-border Workers

Canadian HSWs working abroad remain taxable in Canada on their employment income. However, a special tax credit is available to individuals working overseas on behalf of a Canadian company on projects related to the exploration for or exploitation of petroleum, natural gas, minerals or other similar resources, any construction, installation, agricultural or engineering activity or a prescribed activity (s.122.3 of the ITA). The amount of income eligible for the credit is $80,000 per year.

For a Canadian resident leaving Canada, in certain circumstances he/she may continue to be taxed in Canada. This occurs where the individual, after becoming a non-resident of Canada, continues to be an employee of a Canadian resident corporation and performs all the duties of employment outside Canada, and the income is not subject to tax in a foreign country or the income is not paid in connection with the selling of property, the negotiating of contracts or the rendering of services for the employer in the ordinary course of a business carried on by the employer (s.115(2)(c) and (d)). The exception has the effect of excluding non-resident sales employees of Canadian companies from the deeming rule. Also excluded from the deeming rule are individuals who pay tax on their income in a foreign country (i.e., they are not living in a tax haven).

"Signing bonuses" for entering an agreement to perform services in Canada are also taxable in Canada if the amount is paid by a Canadian resident (s.115(2) of the ITA). For example, if an American HSW received a signing bonus from a Canadian company in 2006 in consideration for his agreement to begin working for the company in 2007, the HSW is deemed to be employed in Canada in 2006 and the signing bonus is taxable in Canada in 2006.

Table 2: Taxation of Employment Income

	Canada	US	China
Moving expense reimbursement	Tax-free	Tax-free	Tax-free
Cost-of-living allowance	Taxable	Taxable	Taxable
Housing allowance	Taxable (reimbursement of loss from sale of previous house is tax-free up to a specified amount)	Tax-free if actual costs are reimbursed	Tax-free under certain conditions
Education reimbursement	Taxable (case law establishes tax-free treatment in respect of children's French education[61])	Taxable	Tax-free
Home-leave allowance	Tax-free	Taxable	Tax-free for one trip

3.4 Employee Stock Options

Historically, employee stock options were granted almost exclusively to senior executives of large companies. In the new knowledge-based economy, however, employee stock options are an important component of compensation for many employees, especially highly-skilled employees who tend to move internationally.[62] As cross-border investment has increased, and human and

[61] *Guay v. R.*, [1997] 3 C.T.C. 276, 97 D.T.C. 5267 (Fed. C.A.). Reimbursement of an employee's children's private school tuition fees from the employer was held to be tax free because the employee was required by his employer to work in different countries.
[62] PWC (2005), supra note 2.

financial capital have become more mobile, it has become more common for multinational enterprises based in the United States and Canada to establish global stock option plans for all employees.[63] The employee stock option rules are somewhat outdated and inadequate.

3.4.1 Canada Rules

Section 7 of the ITA governs the taxation of benefits arising from employee stock options. In general, a stock option, like any other property given to an employee as compensation, will be taxable as employment income[64] when received by the employee. The employee is taxed on the difference between the option price (the amount the employee has paid for the stock) and the fair market value of the stock received when the option is exercised. For example, if an employer provides an employee with an option to purchase shares worth $100,000 for a price of $20,000 (which is the fair market value at the time when the option was granted), if the option is exercised, the employee's taxable benefit will be the $80,000 difference between the $100,000 fair market value of the shares and the $20,000 paid.

The timing of the benefit from stock options is generally whether the option is exercised and the shares purchased. There is no taxable benefit when the employee is given or "granted" an option to purchase shares or when this option right is vested. There are, however, two important exceptions for options acquired by arm's length employees: one is for employees of Canadian controlled private corporations (CCPCs), and another for employees of public companies. In these two cases, the benefit is taxable when the shares are sold.

Where an option holder has ceased to be an employee prior to the happening of the events that would make that provision applicable, subsection 7(4) deems the employment to continue to exist even where the individual is no longer an employee of the company that granted the stock

[63] See Mercer Human Resources Consulting, 2001 Update: *Broad-Based Stock Options* 1 (2001), at 1 (6.3% of large U.S. companies have or plan to make worldwide grants in 2001, up from 4.6% in 1997.

[64] However, the employee is allowed a special deduction under paragraphs 110(1)(d) or (d.1) in computing taxable income. The amount of the deduction is 50 per cent of the taxable benefit. Accordingly, the net inclusion in taxable income is comparable to a capital gain, which is only one-half taxable. As a result, only one-half of stock option benefit is actually taxed. In effect, a stock option benefit is taxed like a capital gain in terms of its inclusion rate, but it is not characterized as a capital gain so it is not eligible for the capital gains exemption and it cannot be offset by a capital loss.

option. In *Hale (J.) v. R* (1992),[65] for example, the taxpayer worked for a Canadian company and was granted stock options. He moved to England and exercised his stock options granted by the Canadian company. The Court held that the stock option benefit was deemed to be income from employment exercised in Canada. The ITA contains no specific apportionment rules to allocate the portion of the stock benefit between Canada and the foreign country. As such, the whole amount of the benefit maybe subject to Canadian tax.

3.4.2 US Rules

Under the US Internal Revenue Code, compensatory stock options are subject to two separate tax regimes.[66] Incentive stock options (ISO)[67] holders are potentially taxed upon the sale of the underlying stock at capital gains rates, whereas holders of non-qualified options (NQO) are taxed, at ordinary rates, on any gain when the options are exercised. ISO issuers receive no tax deduction, but NQO issuers receive a compensation deduction when the holder includes the option gain in income. Consequently, incentive stock options are not nearly as popular as non-qualified options. The disparate domestic tax policies reflected in the treatment of ISOs and NQOs make it rather difficult for the United States to articulate a single, international tax policy for taxing compensatory options.[68]

For US tax purposes, in the absence of special circumstances, compensatory option income should generally be allocated ratably over the appropriate period, and divided between United States and foreign sources based on the percentage of days services are performed in the United States and abroad for each year. If the options are awarded for particular service, however, a different allocation method may be appropriate. Amounts that are foreign source cannot be taxed under section 864(c)(6), since foreign source service income can never be "effectively connected income" for US tax purposes. This is so even if the nonresident was formerly a resident alien and

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[65] [1992] 2 C.T.C. 379, 92 D.T.C. 6370 (Fed. C.A.).

[66] See Jeffrey M. Colón, "Double Dipping: The Cross-border Taxation of Stock Options" (2003) 35 *Rutgers L.J.*, 171.

[67] To qualify as an ISO, the option must satisfy detailed statutory rules pertaining to the grantee's employment status; the minimum holding period between grant, exercise and disposition; shareholder approval of the option plan; the maximum term; the maximum strike price; transferability restrictions; employee stock ownership restrictions; and the maximum amount of the options.

[68] Colón, supra note 66.

the deferred income would have been taxable had it been received while the taxpayer was a resident. The Internal Revenue Service interprets section 864(c)(6) to apply to former resident aliens who receive U.S. source deferred income while a nonresident that is attributable to years of U.S. residency.

3.4.3 Chinese Rules

In China, benefit from employee stock options is taxable as employment income when the employee exercises the option. For non-Chinese citizens, stock option income is taxable if it is considered attributable to Chinese employment. The law is silent on the source rules. In general, a stock option that is granted and vested when the employee is resident in China is considered to be Chinese source income. The amount of taxable income is the difference between the fair market value of the stock and the exercise price. With the approval of the tax authorities, the stock option income may be included in monthly income by averaging it over a period of not more than six months, and taxed monthly at progressive rates of up to 45 per cent.

Table 3: Taxation of Employee Stock Options

	Timing of taxation event	Tax treatment
Canada	• Exercising option (general) • Sale of share (CCPC, and election up to $100,000 in respect of public company share options)	Option benefit is taxable as employment income, but a special deduction is allowed, resulting in only 50% taxation (which is the same as capital gains taxation)
US	• Exercising option (NQO) • Sale of share (ISO)	Option benefit taxable as employment income
China	Exercising the option	Option benefit taxable as employment income

3.4.4 Cross-border Issues

The tax treatment of stock options in the cross-border context raises many challenging questions with respect to: (a) timing of taxation -- the tax policies adopted run the gamut from taxation upon grant, lapse of vesting, exercise, or the ultimate sale of the underlying stock; (b) characterization of the benefit as employment income or a capital gain (because options represent an interest with respect to stock, some portion of option income may be treated as capital); and (c) the territorial source of the benefit. For the employee, these may result in double (or multiple) taxation of the same economic income. For the government, there is the worry that the option benefit may not be taxed in any country. Although tax treaties are intended to foster the international movement of capital and persons by mitigating double taxation, in many situations, the treaty rules are inadequate.

Double taxation could arise when the source rules are different. In *Tedmon v. R.,*[69] the taxpayer was an American citizen who was granted the option to purchase the stock of his U.S. employer company (General Electric) while living in the United States. He exercised the option after moving to Canada. He was held taxable in Canada on the difference between the value of the shares on the date that they were acquired and the exercise price under the option plan. Under US law, the portion of the benefit from the stock option is considered to be US source income and subject to US tax. Worse still, the US may not recognize the Canadian tax for its foreign tax credit purposes.

Similar double taxation arises: (a) when a person receives options in one country where he/she is taxed on receipt of the option (such as in Belgium) and moves to another country that taxes upon exercise of the option (such as Canada and the United States); and (b) when a person moves from one country that taxes the benefit when the share purchased under the option is sold (e.g., the United States in respect of "incentive stock options") to a country that taxes the benefit when the option is exercised (e.g., Canada); or (c) when a person moves between two countries that have the same timing rules for taxing the benefit, but one country taxes it on a source basis

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[69] [1991] 2 C.T.C. 2128, 91 D.T.C. 962 (TCC).

and another taxes it on a residence basis. None of the Canadian treaties specifically address the issue of stock options.

4. PENSIONS

Pensions represent deferred wages or salaries. Membership in an occupational pension plan is important forms of compensation, especially to HSWs. Canada, the United States, China and many other countries provide tax subsidies to private retirement savings plans by allowing a deduction for contributions made to a qualified plan and a tax exemption of income earned within the plan. In addition to employer-sponsored pension plans, there are tax-assisted individual-based retirement savings plans which are an important part of the financial planning for individuals. When a taxpayer moves between countries, he/she may be able to retain membership in the home-country's pension plan during the assignment overseas or to join a pension plan in the host country or in a third country (such as an offshore pension plan created for expatriates). There are significant issues arising from the interaction of the different pension arrangements that are primarily designed on the basis of purely domestic policy considerations. This part overviews the pension system in Canada, the United States and China and the cross-border issues for mobile HSWs.

4.1 Canadian Pension System

The Canadian pension system has three tiers. Tier 1 is an income-tested minimal income security system consisting of the Old Age Security, Guaranteed Income Supplement and Survivors and Spouses Allowance programs. It provides a uniform flat rate benefit to all eligible Canadians aged 65 or older who meet the residency requirements.[70] Tier 2 is a mandatory public pension system, consisting of the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP). They operate on a pay-as-you-go basis: benefits are financed primarily by contributions from employers and employees, and the self-employed. Tier 3 is the tax-assisted private pension

[70] As of 2001, average wage in Canada is $31,757: see 2001 census data on the average wage online: <http://www12.statcan.ca>.

system, including employer-sponsored registered pension plan (RPP) and individually-based registered retirement savings plans (RRSPs).

RPPs are pension plans sponsored by employers in the private or public sector that have been accepted and registered by the Minister of National Revenue for purposes of the ITA (s.147.1). It is the most important type of private pension plans in terms of assets accumulation and coverage.[71] An RRSP is a retirement savings plan set up by individuals that qualify for the deductions under section 146 of the ITA. By its nature, all RRSPs are in individual accounts, managed directly by the taxpayer or a financial service provider. High-income individuals are more likely to participate in RRSPs because they have the necessary financial resources and receive more tax savings with the RRSP deductions.

RPPs and RRSPs are tax-assisted plans. The tax assistance is provided in the form of a current deduction for contributions, and a tax exemption of investment income earned by the pension plan. Funds in a RPP or RRSP are not taxed to the beneficiary until they are withdrawn from the plan. At present, there is a universal limit for the maximum amount of tax-deductible contributions to all types of tax-assisted pension plans: 18 percent of last year's earned income up to the specified dollar amount (currently $15,500). Individuals who are covered by RPPs generally exhaust their limit and have no contribution room left for RRSPs. In other words, RRSPs are inversely related to the generosity of RPPs. Therefore, RRSPs are used mostly by individuals who do not belong to any RPP.

4.2 US Pension System

The American pension system is largely similar to the Canadian system. It also has a public pillar – the social security system, which is a mandatory and universal pay-as-you-go program providing earnings-related benefits that covers over 95% of the working age population. Aliens working in the United States must contribute to the social security system. Employer-sponsored plans that meet the legal requirements are referred to as qualified plans. Contributions by the

[71] Canada, Statistics, "Pension Plans in Canada: January 1, 2003" , (Ottawa: Statistics Canada, Pensions Section, 2004) at 6.

employer and employee are tax-deductible. Investment earnings accumulated within a qualified plan are tax-exempt. In addition to employer provided occupational pensions, many workers also rely upon personal savings in the form of individual accounts, such as 401(k) plans or IRA (individual retirement accounts). A 401(K) plan is a company-sponsored pension plan for the company's employees, which is named after the Internal Revenue Code section setting out the rules for such plans. The 401(K) plan is generally referred to as a deferred arrangement since the employee has the option of taking the employer's contribution in cash or having it paid into the plan as an election contribution. Where the employee elects to transfer an amount to a 401(k) plan, the transfer reduces the employee's salary. The annual employer transfer is limited. Under the Internal Revenue Code, the employer contributions and the earnings within the plan are tax deferred to the employee until withdrawn from the plan, at which time the amount received is fully taxable.

An individual retirement account (IRA) is similar to the Canadian RRSP in many respects. There are limits on the amount of tax-deductible contributions that may be made annually to the IRA.[72] The taxation of income earned in the IRA is deferred until the income is distributed. As part of the Taxpayer Relief Act of 1997, another type of IRA was introduced, known as the Roth IRA (named after the senator who sponsored the legislation). A Roth IRA is different from the regular IRA in that contributions to a Roth IRA are not deductible, but investment income accrues on a tax-free basis and distributions are generally not taxable (Internal Revenue Code s.408A(c) and (d))

4.3 Chinese Pension System

Pensions are new in China. On the basis of the recommendations of the World Bank, China adopted a three-pillar pension system in the mid-1990s. Pillar 1 is a mandatory public pension system, consisting of two components: the pay-go-based or social pooling component and individual pension accounts. It is designed to provide a basic pension of up to 40% or 45% of the average salary at the time of retirement. Pillar 3 hardly exists at present and is not supported by any specific government policy or regulation.

[72] I.R.C. s. 219.

Pillar 2 is a voluntary, supplementary enterprise annuity system, which is similar to the Canadian RPP scheme in nature.[73] An enterprise annuity fund is a supplemental occupational pension fund created by the contributions and the accumulated investment earnings. The assets of a pension fund are segregated from those of the sponsoring enterprise. The fund is managed by a trustee. Enterprise annuity funds are all defined contribution plans. An employee's beneficial interest in an annuity fund cannot be transferred to a non-qualified plan.

4.4 Cross-border Issues

Cross-border issues arise from the differences in the general tax policy that countries adopt with respect to retirement savings with respect to: (a) the tax deductibility of contributions made to a foreign pension plan or contributions made by a domestic employer to a domestic plan in respect of a non-resident employee; and (b) the allocation of tax jurisdiction over pension benefits paid by a pension plan to a person living in a foreign country. Another major issue is the lack of transferability of pension interest from Canadian plans to foreign plans, and vice versa.

4.4.1 Contributions to Canadian Pension Plans

For outbound mobile workers, whether they remain covered by their RPP or RRSP is likely a serious issue. Contributions to RRSPs are relatively straightforward. As long as a mobile worker retains his/her Canadian residence and files a tax return, tax-deductible contributions can be made. Contributions to a RPP are more complex. S. 8503(3)(a) of the Income Tax Regulations limits the periods for which an RPP can provide benefits under a defined benefit provision to an individual working overseas to a five-year period. It permits an RPP to provide benefits for the limited period throughout which a plan member is employed outside Canada, as in the case of an individual working at a foreign branch or subsidiary of the Canadian company. If the individual is taxable in the host country on his/her employment income, the value of the RPP contributions made on his/her behalf is likely taxable as employment benefit.

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[73] See Ministry of Labour and Social Security, "Trial Measures on Enterprise Annuities," January 6, 2004, with effect from May 1, 2004. For a discussion, see Jinyan Li, "Enterprise Annuities in China: Regulatory Framework, Practical Challenges, and International Opportunities," (2005) no.52 *International Pension Lawyer* 39-53.

HSWs moving to Canada will be able to contribute to their employer-sponsored RPPs. However, there is a general two-year vesting period. While a worker may have contributed to an RPP, if he/she changes employment, he/she will not qualify for RPP benefits upon retirement. RRSP contributions are tied to previous year's earned income. As such, an immigrant is not eligible for making any RRSP contribution during the first year in Canada. In contrast, QPP/CPP contributions are made on the basis of employment earnings in Canada. If the employer is a foreign company that has an "establishment in Canada" (e.g., an office or a branch), coverage of the employment of all eligible employees in Canada is mandatory under the CPP. If the employer does not have an establishment in Canada, coverage of the employment of employees in Canada may be obtained by applying for coverage under s.22(2)(a) of the CPP Regulations.

4.4.2 Contributions to Non-Canadian Pensions

The tax treatment of contributions to foreign pension plans affects workers who move to Canada as well as Canadian companies that have employees transferred from their foreign affiliates into Canada. These workers may continue to be members of foreign pension plans. Such plans are not normally registered in Canada, nor are these plans subject to Canadian laws regarding maximum pension entitlements. As such, these foreign plans are not RPPs for tax purposes.

Under the general rules of the ITA, contributions made by a Canadian resident to foreign employer-sponsored pension plan are not deductible in computing Canadian income. The value of contributions made by the employer is generally taxable benefit to the Canadian taxpayer. The tax treatment of the employer contributions to a foreign pension plan generally depends on the characterization of the plan as an "employee benefit plan" (EBP) or a "retirement compensation arrangement" (RCA). Each type of plan has its own particular application and tax implications.

A EBP is an arrangement under which (a) the employer makes contributions to a third-party custodian, and (b) one or more payments are made to, or for, the benefit of employees, former employees or persons with whom the employees and former employees do not deal at arm's length. For Canadian tax purposes, contributions made by the employer to an EBP and any income earned on their accumulation in the plan are not taxed in the hands of the employee. When the employee receives amounts out of the plan (except to the extent that they represent a return of the employee's own contributions), those amounts are taxable as employment income. Such a plan is different from an RPP because no tax deduction is permitted for contributions made by an employer to the plan on behalf of employees who are resident in Canada or are performing services in Canada.[74] However, employer contributions are deductible if the following conditions are met: the plan's custodian is not a resident in Canada; the employee was a member of the plan prior to becoming a resident of Canada; and the employee was a Canadian resident for no more than 60 of the 72 months preceding the date on which the services were rendered.[75]

RCAs generally include any arrangement under which contributions are made by the employer to a third-party custodian in connection with benefits to be received by the employee upon retirement or termination from employment (s.248(1) of the ITA). When contributions are made to an RCA, there are no immediate tax consequences for the employee. From an employer's perspective, however, contributions are deductible in the year payment is made, but a separate tax is levied. This tax equals 50% of all contributions made to the RCA. This tax is refundable when the custodian makes payments out of the RCA to the beneficiaries. There is another refundable special tax on the income earned in the RCA, which is 50% of income less 50% of all amounts paid as distributions. The tax is refundable (payable back to the trust), but collectible only when distributions are made from the RCA or certain elections are made. Payments made to an RCA beneficiary are taxed as income (s.56(1) of the ITA).

Based on the definitions of the EBP and the RCA, all foreign pension plans are generally EBPs for the first 60 months that the employee is a resident of Canada, assuming the preceding conditions are met. Any payments to the plan for services rendered after the 60-month window

[74] S.18(1)(o) of the ITA prohibits an employer from deducting contributions to an employee benefit plan when paid. S.32.1 provides a deduction when the contributions are used to pay benefits.

[75] Subsection 18(1) contains an exemption from s.18(1)(o) for contributions paid to a foreign-based plan in respect of non-residents or short-term residents. In addition, where a foreign pension plan is treated as an employee benefit plan, the pension adjustment rules need to be considered. A pension adjustment must be reported by an employer under s.8300 of the Income Tax Regulations where amounts were contributed to a foreign pension plan on behalf of the employee.

are deemed to belong to a separate plan, subject to the RCA rules.[76] The employer is allowed to elect out of the RCA rules in respect of contributions made for the benefit of a Canadian resident after the 60-month window. The effect of the lection is to have the EBP rules apply and the employer will be required to report a pension adjustment in respect of the contributions made. The pension adjustment will reduce the employee's contribution room for the RRSP. This election is available only if the foreign plan is subject to favorable tax treatment in the home country, and the employer must file a letter with the CRA to make the election.

A small number of Canadian tax treaties contain a provision requiring the country of residence (or temporary presence) to give a deduction for contributions to a pension plan recognized for tax purposes in the other treaty country if specified conditions are met.[77] In its application to Canada, this treaty provision typically provides for the following conditions: (a) the contributions are paid by, or on behalf of, an individual who is resident or temporarily resident in Canada; (b) the contributions are paid to a pension plan that is recognized for tax purposes in the other treaty country; and (c) the contributions are made in a year in respect of services rendered in that year. This provision is found in the treaties with Chile, Estonia, France, Latvia, Lithuania, the Netherlands, South Africa, Sweden, and Switzerland. In the absence of such treaty provisions, employee contributions to foreign pension plans are generally not deductible, although employer contributions are.

4.4.3 Special Canada-US Issues

American HSWs coming to work in Canada may remain eligible for contributing to US tax-assisted pension plans. For Canadian tax purposes, the 401(K) plans are treated as either an EBP or RCA (see above). An IRA is treated as a "foreign retirement arrangement" under S.6803 of the Canadian Income Tax Regulations. As such, there will be no immediate tax consequences with

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[76] Notwithstanding the tax implications to the employer that occur when a foreign pension plan undergoes recharacterization from an EBP to an RCA, the employee's membership in the foreign plan will result in additional tax considerations relating to his or her ability to accrue retirement benefits under a Canadian registered retirement plan - such as a registered pension plan (RPP), a deferred profit-sharing plan (DPSP), or a registered retirement savings plan (RRSP).

[77] For more discussion of tax treaties and pensions, see William Holmes, "Tax Treaties and Pensions" in Arnold B & Sasseville J., eds., *Special Seminar on Canadian Tax Treaties: Policy and Practice*. International Tax Seminar Held May 15-16, 2000 (Kingston, Ont: International Fiscal Association, 2001) at 20:1.

respect to contributions made to the plan and the income earned in the plan while the individual is a Canadian resident. Moreover, it is possible to rollover US plans (including 401(k) and IRAs) into Canadian RRSPs pursuant to s.60(j) of the ITA. For US tax purposes, the US plan is collapsed and the withdrawals amount is subject to a US withholding tax at 15 percent (as reduced by the Canada-US Treaty, Art.XXII). For Canadian tax purposes, the withdrawal amount is included as income, but a deduction under s.60(j) for the amount transferred to an RRSP can offset the income inclusion.[78] If an individual prefers to retain the US plans, Article XVIII(7) of the Canada-US Tax Treaty allows him/her to defer the Canadian taxation of income accruing in the US plan.

For Canadian HSWs moving to the United States, the United States does not provide a similar rollover for Canadian RRSPs. Therefore, a transfer of Canadian RRSPs to a US plan would be considered a distribution under Canadian law, and would trigger taxation in both countries. If these individuals leave the RRSP intact, in the absence of the above-mentioned treaty-based deferral, even though Canadian RRSPs are similar to US IRAs, they do not meet the requirements for qualification as IRAs under section 408(a) of the Internal Revenue Code. As a result, the earnings of RRSPs are currently taxable in the US. In order to qualify for the deferral under XVIII(7) of the treaty, the earnings must be attributable to contributions made during periods of Canadian residency. An election to defer US taxation must be made each year. The purpose of this provision is to avoid a mismatch of U.S. taxable income and foreign tax credits attributable to the Canadian tax on such distributions. By deferring U.S. tax on earnings in the plan attributable to Canadian contributions until there is a distribution, U.S. tax generally will be imposed in the same years that Canadian tax is imposed, so that the taxpayers may credit the Canadian tax against their U.S. tax liability.

With respect to social security programs, the cross-border integration is more sophisticated. Where an individual who has been working in Canada and contributed to the CPP is assigned by his/her employer to work in the United States temporarily, he/she is allowed to: (a) continue to pay into the CPP for the work in the United States; (b) to have the periods spent in the United

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[78] For a technical explanation of the steps of completing the rollover, see Sandy Cardy and Carol Bezire, "Transfer of U.S. Retirement Plans to RRSPs Can Be Non-Taxable", (2005) *Advisor's Edge* (December 2005) 27-31.

States considered as residence in Canada for purposes of the OAS program, and (c) be exempt from contributing to the US Social Security Plan. Similar rules apply to Americans coming to work in Canada.

4.4.4. Pension Benefits

With respect to outbound workers, pension benefits paid out of Canadian plans (private and public) are generally subject to Canadian withholding tax at the rate of 25% of the gross payment pursuant to s.212(1)(h) for RPP benefits, s.212(1)(l) for RRSP payments and s.212(1)(j) for RCA payments. A non-resident can elect under s.217 of the ITA to pay tax on a net basis at progressive rates, as opposed to the 25% withholding tax on gross amounts.

Canada's tax treaties generally contain a wide variety of pension provisions, although some treaties (such as the Canada-China treaty) do not have any pension provision. The most detailed provision is found in Article XVIII of the Canada-US Tax Treaty. In accordance with Article XVIII, "pensions and annuities" arising in one treaty country and paid to a residents of another country may be taxable in the residence country as well as the source country, but the source country's withholding tax rate is limited to 15 percent of the gross payment. The term "pension" is defined to include "any payment under a superannuation, pension or other retirement arrangement". Thus, the definition of "pensions" includes payments from US IRAs and similar arrangements, and Canadian RRSPs and RPPs. The term "annuities" is defined to mean "a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered), but does not include a payment that is not a periodic payment or any annuity the cost of which was deductible for the purposes of taxation in the Contracting State in which it was acquired".

Payments out of public pension programs are subject to different rules under the Canada-US Tax Treaty – they are taxable only in the country of residence. Therefore, CPP/QPP and OSA payments made to a US resident are taxable only in US. For US tax purposes, these payments are treated as US social security benefits, i.e., the taxable portion varies with income level and filing status. Under the Internal Revenue Code s.871(a)(3), 85 percent of social security benefits paid to a non-resident alien are includible in gross income. Therefore, US recipients of Canadian payments will be taxed only on 85 percent of the payment, even though the entire benefit would have been taxed by Canada if it were received by Canadian residents. When Canadian residents receive payments from US social security programs, the same treaty rules apply. No U.S. tax is payable on social security payments.

Table 4: Tax Treatment of Pensions

	Canada	US	China
Employee Contributions to **domestic** plans	Tax-deductible	Tax-deductible	Not tax deductible
Employer contributions to domestic plans	Tax-free to employee Deductible to employer	Tax-free to employee Deductible to employer	Tax-free to employee Deductible to employer
Employee contributions to **foreign** plans	Not tax-deductible	Not tax-deductible	Not tax-deductible
Employer contributions to **foreign** plans	If EBP, tax-free benefit to employee, tax deductible to employer If RCA, special tax on the employer	Generally not tax-favoured	Not tax-deductible
Benefits paid to non-residents out of Canadian private pension plans	Canadian withholding tax at 25% (reduced by treaties)	US withholding tax	No specific rules yet
Income accrued to **domestic** pension plans	Tax exempt	Tax exempt	Tax exempt
Income accrued to **foreign** pension plans	Currently taxable	Currently taxable	No specific rules yet
Benefits paid to non-residents out of Canadian private pension plans	Canadian withholding tax at 25% (reduced by treaties)	US withholding tax	No specific rules yet

5. SUMMARY OF PERTINENT FEATURES FOR MOBILE WORKERS

This part summarizes the pertinent tax and pension features for mobile HSWs. The summary is organized along the line of inbound mobility and outbound mobility in respect of the following issues: Canadian residence and non-Canadian income, deemed disposition of property upon change in residence, employment income (including employee stock options); and pensions. In addition, special issues pertinent to the employer of temporary migrant workers, especially individuals on intra-company assignments, are noted.

5.1 Inbound Mobility

5.1.1 Canadian Residence and Taxation of Non-Canadian Income

Upon becoming a Canadian resident, an individual is subject to Canadian tax on his/her worldwide income. Foreign income earned directly by the individual is taxable in Canada. Such income is likely taxable in the foreign country as well. In such cases, the individual can claim a foreign tax. Moreover, foreign investment earned indirectly through a controlled foreign corporation, a foreign trust or mutual fund may be imputed to the individual by virtue of the anti-avoidance rules. The individual may be able to eliminate the imputed tax for up to 60 months if the assets are placed in a properly structured non-Canadian immigration trust. Such a trust is not feasible for every individual since there is a considerable cost associated with implementing the trust, hence substantial assets are required to make this arrangement beneficial.

In the case of an immigrant being taxed as a resident in their “old” country, the dual residency problem is solved by the tie-breakers in the applicable treaty. If the old country has no treaty with Canada, the individual may be subject to double taxation. Canada provides no relief for this type of double taxation.

To the extent that the individual is an American citizen, the individual must file a US income tax return for the year and report his/her worldwide income. The individual can elect to exclude up to US$80,000 of Canadian income earned during the period of Canadian residence as well as certain employer-provided housing costs. The United States also allows a foreign tax credit to be claimed for Canadian income taxes on the individual's Canadian income exceeding US$80,000.

5.1.2 Deemed Disposition of Property

When an individual becomes a Canadian resident, he/she is deemed to have disposed of all of his/her property immediately prior to immigration for proceeds of disposition equal to its fair market value, and to have reacquired the property at the same value. When the property is actually sold by the taxpayer, the deemed value is used in calculating the gain or loss on the property. Only post-immigration gain is thus taxable in Canada. If the individual is a returning former Canadian resident, he/she may elect to unwind the deemed disposition that occurred on emigration. If the individual is a short-term resident in Canada, the property owned by the taxpayer at the time of becoming a Canadian resident and inherited property are excluded from the deemed disposition rule.

5.1.3 Employment income (including stock option benefit)

Inbound mobile workers are taxable in Canada on their employment income, which is broadly defined to include wages, salaries, fringe benefits and benefits from employee stock options. If the stock option benefit is also taxable in the foreign country, the foreign tax may not be creditable against Canadian tax. In the case of an individual coming from the United States, if he/she has unexercised stock options granted to him/her by the employer, the stock option is not subject to the deemed disposition and acquisition rules on entry to Canada. However, if the option is exercised while the individual is a resident in Canada, Canada taxes the benefit equal to the difference between the fair market value of the shares at the date of exercise and the exercise price. There is a mismatch in timing of the taxation event with respect to an incentive stock option because the US tax is generally not payable until the shares are sold, whereas Canadian tax is payable when the shares are bought.

5.1.4 Pensions

Individuals who become Canadian residents will not be eligible to contribute to an RRSP in the first year of their Canadian residence. RRSP contributions will start in the following year. Any contributions made to pension plans in the “old” country are generally not deductible in computing Canadian tax. In the case of a former US resident, the individual’s RRSP contributions in Canada will not be deductible for US income tax purposes. However, pursuant to article XVIII(7) of the Canada-US Treaty, the individual can defer US federal tax on any income earned in the RRSP during the year.

For individuals coming to Canada on corporate assignment, continued participation in the home-country pension plan may be an important issue. He/she may already have a significant number of years of vested pension service, and the impact of the Canadian assignment on any future pension benefit entitlement can raise concerns. If he/she remains in the foreign plan, it is important to understand the Canadian tax treatment of his/her contributions and the employer’s contributions. As discussed in Part 4 above, the Canadian rules are very complex. In general, where the individual is resident in Canada for less than 60 of the preceding 72 months and the individual was a member of the plan before establishing residence in Canada, he/she will be subject to the EBP rules. As such, the individual is not taxable on the employer’s contributions to the EBP or on the earnings in the EBP, and he/she cannot deduct his/her contributions to the EBP. The individual is taxable in Canada on any amounts received out of or under an EBP while he/she is a Canadian resident. If the individual is a non-resident at the time of receipt, he/she will be taxable in Canada only on the amount attributable to the employment services rendered in Canada or rendered while a Canadian resident. Tax treaties may provide an exemption of such receipts from Canadian tax if the individual is a non-resident at the time of the receipt.

In the case of the US 401(k) plans, employer contributions for the first 60 months after the individual has been resident in Canada will qualify as contributions to an EBP. The employer will be required to report a pension adjustment with respect to the benefit realized by the employee during the year. If the employee has established a RRSP in Canada, the pension adjustment will reduce the amount that he/she can contribute to the RRSP.

If a foreign plan does not qualify as an EBP, the RCA rules will apply. Employer contributions to a RCA are deductible, but they are subject to a 50% refundable tax. Income earned on the assets of the RCA will also be subject to the 50% refundable tax. When the plan distributes amounts to the individual, the refundable tax will be refunded. If the employee is a Canadian resident at the time of the payment, the distributions from the RCA will be taxable to the employee. If the employee is not a Canadian resident at the time of the payment, he/she will be subject to Canadian withholding tax on the distributions.

5.1.4 Implications for Employers

As far as the employer of a mobile worker is concerned, three potential tax issues may arise from sending a worker to Canada for a period of time. The first issue is whether the activities of the worker will be imputed to the employer such that the employer may be considered to carry on a business in Canada. If so, profits attributable to these activities are taxable in Canada under s.2(3) of the ITA. It is likely that the employer is considered to be carrying on a business in Canada if the worker spends a significant amount of time in Canada, and authorizes or concludes contracts on behalf of the employer. Under the Canada-US or Canada-China treaty, however, the magnitude of this problem is reduced and the Canadian tax exposure is avoided unless the activities in Canada constitute a permanent establishment.

The second issue relates to intra-company assignments. If a HSW is assigned to work at a Canadian subsidiary of a foreign corporation, Canadian tax rules require the cost of the remuneration be “reasonably” allocated to the Canadian subsidiary.

The third issue is the withholding obligation of the employer. S.153 of the ITA requires the employer to deduct Canadian tax from the amount of remuneration paid to the employee and remit it to the Canadian government. Failure in compliance will result in tax penalties. In the case of an intra-company assignments where there is a chargeback to the Canadian corporation by the foreign corporation for the cost of the individual's services in Canada, the Canadian corporation is required to withhold tax from the employment income of the individual. If the activities of the worker give rise to "carrying on business in Canada" or a permanent establishment on the part of the foreign corporation, the Canadian corporation must also withhold tax from the fees paid for the services (s.105 of the Regulations). This tax is refunded if the foreign corporation can rely on a treaty exemption.

Table 5: American Citizens Working in Canada (short-term)

	Canada Tax Consequences	US Tax Consequences
Residence status	Maybe a Canadian resident under ITA, but treaty tie-breakers will assign residency to US	US resident, subject to worldwide taxation
Deemed disposition of property	Not applicable (did not become Canadian resident by virtue of the treaty)	Not relevant
Employment income	Taxable in Canada on Canadian-source income if he/she spends more than 183 days in the year or salary is borne by a Canadian employer or permanent establishment	Canadian income taxable in the US with foreign tax credit for any Canadian tax paid
Employee stock option	Taxed as part of employment income	Same as above
US pension plans	Employee contributions are not tax-deductible in computing income for Canadian tax purposes Employer contributions attributable to Canadian employment may be taxed as employment benefit	Eligible for tax incentives
Implications for employer	Withhold Canadian tax from payroll Employee's activities may give rise to a permanent establishment	Foreign tax credit if any Canadian tax is paid

Table 6: American Citizens Working in Canada (permanent)

	Canada Tax Consequences	US Tax Consequences
Residence status	Canadian resident, taxable on worldwide income Unless an immigration trust is used, offshore investment income earned through a controlled foreign corporation or non-resident trust is currently taxable to the taxpayer	Canadian income taxable as US citizen; May be eligible for the $80,000 exclusion and credit for Canadian tax
Deemed disposition of property upon becoming Canadian resident	Cost of property deemed to be fair market value on the date of immigration	Not relevant
Employment income	Taxable, maybe eligible for the overseas employment credit for up to $80,000	Taxable, with $80,000 exclusion and foreign tax credit
Employee stock option	Taxable, even if option granted while in the US	Portion of the benefit attributable to US services maybe taxable; foreign tax credit may not be available for Canadian tax payable on the same benefit
US pension plans	For the first 60 months of Canadian residence, US pension plans qualify as EBP; US IRAs can be transferred to a RRSP; US IRAs do not give rise to immediate Canadian tax consequences if election to defer taxation is made	Eligible for contribution to IRAs and ROTH IRAs

5.2 Outbound Mobility

5.2.1 Canadian Residence

When an individual departs from Canada, he/she must not assume that Canadian residency is severed at the moment of departure. Whether or not Canadian residence is severed depends on the facts of each case. A person who is physically absent from Canada for a year or more may still be considered as a resident for tax purposes.

5.2.2 Deemed Disposition of Property

Under the departure tax, each property (with the exception of the excluded property) owned by the outbound HSW is deemed to have been disposed of, resulting in a gain or loss for tax purposes. In order to minimize the double taxation of the gain as a result of departure tax, the Canada-US treaty provides some relief. Such relief is not available in the Canada-China treaty and many other treaties. If the outbound individual has been a resident in Canada for no more than five years, the property brought to Canada upon immigration and property inherited during Canadian residence are not subject to the deemed disposition.

5.2.3 Employment Income (including Employee Stock Options)

After becoming a non-resident of Canada, an individual is no longer taxable in Canada on his/her worldwide income. Instead, only income earned from Canadian sources is taxable in Canada. However, in the case of employee stock options, a former resident remains taxable in Canada on stock options that were granted by virtue of the individual's employment while a Canadian resident. This Canadian tax may or may be recognized in the "new" country, resulting in potential double taxation. Moreover, a former Canadian resident may be deemed to be employed in Canada if he/she received remuneration from a Canadian resident, and the remuneration is exempt from tax in the foreign country by virtue of a treaty with Canada.

5.2.4 Pensions

An individual ceasing to be a Canadian resident will be exempt from the departure tax in respect of his/her RRSPs. He/she will no longer be eligible to contribute to RRSPs on a tax-preferred basis. If funds are withdrawn from a RRSP while the individual is a non-resident, a 25% Canadian withholding tax (subject to treaty reduction) is imposed on the amounts withdrawn. Canadian RRSPs have no preferred status under the tax laws of foreign jurisdictions.

As such, income accruing in the RRSP would normally be taxed in the foreign jurisdiction on an annual basis. Canadian tax treaties do not generally provide effective relief, although Article XVIII(7) of the Canada-US Tax Treaty provides a deferral option to individuals moving across border.

If a departing individual continues to be employed by a Canadian corporation, such as someone who is transferred to work at a foreign branch or subsidiary of a Canadian company, he/she may continue to participate in the RPP sponsored by the company and accrue benefits for the first five years of employment outside Canada. This means that the employer contributions to the RPP are not taxable to the employee under Canadian law. However, such contributions are generally taxed as taxable income to the individual in the foreign country.

5.2.5 Implications for Employers

The major tax implication for Canadian employers is the departing worker's participation in the RPP. With respect to foreign tax implications, there may be an issue of whether the worker's activities constitute "a business activity carried on for the employer or a permanent establishment. There may also be an obligation to withhold tax from the wages or salaries paid to the worker. The amount of foreign tax to be withheld will be determined by the foreign tax law and the applicable treaty.

Table 7: Canadian Residents Working in the US

	Canada Tax Consequences	US Tax Consequences
Canadian residence status	Canadian resident, taxable on worldwide income	Taxable in the US only on US-source income
Departure tax	Not applicable if no change in residence status	Not relevant
Employment income in the US	Maybe eligible for the overseas employment tax credit (up to $80,000) per year	US-source employment income taxable in the US, unless the individual is in the US for less than 183 days in a year and the remuneration is not borne by a US employer or a US permanent establishment
Employee stock option benefit	Taxable upon exercise of option or sale of shares	Portion of the benefit attributable to US services may be taxable in the US
Pension contributions	Eligible for tax preferences in respect of RRSPs and RPPs	Generally not eligible for tax-assisted IRAs or similar retirement plans

6. POLICY ASSESSMENT

The previous parts of this paper examined some major technical tax and pensions issues, including the tax implications of changing residence, employee stock options, and contributions to and payments from pension plans. This part provides a policy analysis and identifies the key objectives of the tax policy.

6.1 Objectives of Tax Policy

Whether a tax rule is good or bad is generally assessed in accordance with some well-accepted tax policy criteria, such as equity, efficiency, and international competitiveness.[79]

[79] For a similar list, see Neil Brooks, "Future Directions in Canadian Tax Law Scholarship" (1985) 23 *Osgoode Hall L.J.* 441, at 457–473, reviewing the literature on tax policy.

Equity (or fairness) requires a fair sharing of the tax burden based on the taxpayer's ability to pay. This calls for vertical equity (people with higher income should pay income tax at higher rates) and horizontal equity (people with the same income should pay the same amount of tax). Both aspects of tax equity have influenced the design and development of the Canadian individual income tax system. Progressive taxation reflecting vertical equity is a hallmark of the system. Traditionally, equity is measured against the backdrop of the domestic context; distributive justice to be achieved through progressive taxation is largely an issue of domestic politics.

The notion of efficiency is also referred to as neutrality. Ideally, taxes should be neutral and should "bring about a minimum change in the allocation of resources within the private sector of the economy".[80] In a neutral tax system, people's decision to move across countries would be no different than if they had been in a world without taxes. To the extent that behaviour is influenced by the tax system, the effect of the tax system is not neutral. Of course, a tax-induced change in behaviour may be desirable, but most tax-policy experts agree that the use of a tax system to accomplish social and economic goals is usually less effective and more expensive than the use of other policy instruments. In many cases, however, tax-induced changes in behaviour are not desirable, and may not be intended by policy makers.

Efficiency is often argued in support of a country's goals of international competitiveness. International competitiveness often suggests that Canadian tax rules should not only be neutral in the sense of not creating barriers to global mobility of capital, but should also "encourage" or "attract" global capital to Canada. The latter sense of efficiency requires the use of tax incentives.

6.2 Barriers to Mobility

The use of the word "barrier" presupposes my assessment of the current Canadian system as violating the tax policy objectives of neutrality or efficiency. So, how serious is this violation? To begin with, the barriers identified in this paper are not necessarily intended by design. The

[80] Canada, Report of the Royal Commission on Taxation, 6 vols. (Ottawa: Queen's Printer, 1966), at vol. 2, 8.

barriers exist mainly because of the inefficient integration of national tax laws in the context of border-less situations, such as the case of international mobile workers. Unlike company taxation or capital taxation, individual income taxation has been regarded as a purely domestic issue. Personal income tax systems are considered closer to sovereignty and personal income tax policies generally reflect the social and political inspirations of the citizens of a country. As such, although much coordination and harmonization has taken place in the area of corporate taxation, especially in respect of the treatment of multinational enterprises and foreign direct investment, personal income tax systems remain more or less localized. When locally-based taxes are applied to a global situation, inconsistencies and gaps are bound to exist, resulting in barriers to global mobility.

The first barrier arises from the potential "harshness" and uncertainty resulting from the definition of "residence" and the related tax consequences therefrom. The concept of "residence" for Canadian tax purposes is determined on the basis of an individual's physical presence in Canada and their social/economic ties with Canada. Canadian residency defines the scope of his/her Canadian tax liability. A person resident in Canada *at any time during the year* is liable to Canadian income tax on income earned in Canada and foreign countries (worldwide income). Even when temporary mobile workers and intra-company transferees are physically present in Canada for a short period of time, they may be taxed as Canadian residents. What is worse, the same income is often taxed in their home country, causing international double taxation. The double taxation may be reduced by the tax treaty tie-breaker rules, but this does not apply in all cases. For individuals who immigrate to Canada, the acquisition of Canadian residence for tax purposes is expected. However, they may also be surprised to discover that once they become Canadian residents, they are taxed not only on the foreign income earned directly, but also on imputed foreign investment income earned through foreign corporation, trusts or mutual funds. The tax relief for "immigrant trusts" is helpful only if the HSW is aware of it and actually takes advantage of it.

Another potential tax barrier to global mobility of high-skilled workers is the "departure tax" on the accrued capital gain. The gain is a paper gain only. Because Canadian tax is generally imposed on gains when the property is sold, this tax on paper gain could be perceived as a "punishment" for giving up Canadian residence. There is also double taxation of the paper gain when the same gain is taxed again in the immigration country at the time when the property is actually sold. Tax treaties generally do not address this type of double taxation. Canada is one of several countries in the world to impose a departure tax.

The third barrier arises from the mismatch of rules for computing income, characterizing income, and the timing of events giving rise to taxation. There could be multiple taxation of the same benefit if the taxpayer has moved among several countries. No effective mechanism exists to remove such double or multiple taxation. Canadian tax treaties do not specifically address the treatment of stock options.

Finally, barriers in the case of cross-border pensions are beginning to affect a large number of individuals. Many pension issues relate to mismatches resulting from differences in the general tax policy that states adopt with respect to retirement savings. In Canada, the United States and China, tax incentives are provided for pension contributions. However, these tax-favored pension plans must meet strict conditions set forth in the tax legislation, which was designed for an immobile workforce: services performed outside of Canada are generally not recognized and pension entitlements are not portable across the border. Foreign pension plans are not recognized for Canadian tax purposes. As a consequence, international mobile workers are unable to benefit from the generous tax subsidies for retirement savings. Moreover, pension benefits under many defined benefit plans are computed by a formula that takes into account the number of years of contribution made by the plan member and the average earnings of the plan member immediately before retirement. When a skilled worker moves to or from Canada in his/her mid-career, he/she often loses some of the benefits. There is also a potential double taxation of the benefits paid by pension plans to its members who have moved to a foreign country.

To some extent, these barriers reflect the traditional model of labour mobility and the "brain drain" perspective. When the ITA was first introduced in 1917, globalization and cross-border labour mobility were presumably insignificant factors. More recent amendments have "modernized" the ITA by attempting to address the mobility issue. For example, s.128.1(4) provides for an exception to the departure tax for individuals who move to Canada for a period of less than five years; s.94(1)(b)(i)(A)(III) provides for a five-year non-taxability of income earned through an offshore trust established for new immigrants; s. 6803 of the Income Tax Regulations recognizes foreign pension plans for limited purposes; and s.60(1)(j) permits rollover of U.S. IRAs to Canadian RRSPs. In light of the recent "brain circulation" theory and the importance of skilled labour to Canadian global competitiveness, it is time to remove the barriers identified in this paper and to make the Canadian tax/pension system more competitive. Of course, it is not enough to simply make changes to the ITA, because some barriers can only be removed through international efforts. Canada needs to develop a new treaty policy in order to better coordinate Canadian tax law and the law of the other treaty country.

7. POLICY RECOMMENDATIONS

7.1 Changes to Domestic Law

7.1.1 Personal Income Tax Rates

This paper does not recommend Canada to lower personal income tax rates just to attract mobile workers to Canada. Canadians as a whole should enjoy the sovereignty over the determination of what type of social justice they want to see achieved through progressive taxation. Naturally, Canada is not an isolated country and must consider the implications for international competition for mobile capital and labour. However, this is only one of many that influence the policy decision. In fact, according to the survey of 20 countries[81] by the PricewaterhouseCoopers study in 2005,[82] the top combined federal and provincial income tax rates in Canada are lower than that in nine countries (Austria, Belgium, Finland, France, Germany, Italy, Netherlands, Slovenia, Sweden) and are comparable to that of China, Ireland, Poland, Switzerland, UK and the US. Moreover, marginal tax rate is arguably not a key deciding factor to mobile workers in their choice of destination. Relatively higher Canadian tax rates are presumably compensated, to some extent, by excellent social infrastructure (financed with tax

[81] Australia, Belgium, China, Czech Republic, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Russia, Slovakia, Slovenia, Sweden, Switzerland, United Kingdom, and United States.
[82] PWC 2005, supra note 2, at 25.

revenue), a dynamic business environment, and the natural beauty and environment of the country.

7.1.2 Technical Changes to the Tax Base

In order to remove tax barriers to mobile workers, certain technical rules can be added to the ITA or adopted administratively. For example, with respect to the determination of Canadian residence and the associated Canadian tax consequences, the Canada Revenue Agency can create a brochure or webpage advising mobile HSWs about their Canadian tax consequences in a manner similar to that for film industry services.[83] With respect to the taxation of employee stock options, s.7 of the ITA may be amended by adding a "source rule" that allocates the source of benefit arising from employee stock options on the basis of the place of services performed by the employee during the period of time relevant to the option. With respect to RRSP contributions by inbound HSWs, it might be considered to amend s.146 to allow first-year immigrant to be eligible for contributing to the RRSP.

7.1.3 Tax Incentives

The ITA already contains some "tax incentives" for mobile workers. For example, for outbound HSWs, the "overseas employment tax credit" effectively exempts up to $80,000 foreign employment income from Canadian tax. For inbound HSWs, the immigration trust rule allows foreign investment income accumulating within a non-Canadian trust to be free from Canadian income tax. The Province of Quebec also offers a tax holiday for certain qualifying foreign HSWs.[84] For example, foreign researchers employed by a company in Canada that does R&D in Quebec enjoy a provincial tax holiday in respect of their salary for five consecutive years. The extent of the tax holiday declines from 100% of employment income in the first two years, to 75% in the third year, 50% in the fourth year and 25% in the fifth year.[85]

[83] For more information, see http://www.cra-arc.gc.ca/tax/nonresidents/film/menu-e.html.
[84] For more information, see http://www.immigration-quebec.gouv.qc.ca/anglais/immigration/temporary-worker/guide_employer.html.
[85] For more detail, see http://www.investquebec.com/en/index.aspx?page=487.

Should Canada adopt more pro-active tax policies to make Canada more attractive to mobile HSWs through, for example, offering tax holidays to inbound HSWs similar to the Quebec program, or broadening the immigrant trust rules to exempt all foreign-source income of inbound HSWs from Canadian income tax?[86] Other researchers have mentioned the idea of using tax incentives to attract mobile workers.[87] I do not object to using pro-active tax policies in the above suggested manner, but I would not strongly recommend such policies for the following reasons.

(1) Any preferential treatment of mobile workers would violate the notion of equity. Under the individual income tax system, equity remains a primary objective. Given that the system is based on self-assessment, the perceived fairness and equity of the system is important to tax compliance. It is difficult to defend a tax policy that favours foreign HSWs over Canadian HSWs. There is a potential erosion of public confidence in the fairness of the income tax when it is known that foreign HSWs are allowed concessions.

(2) There is a lack of empirical evidence estimating the potential revenue loss resulting from the tax incentive to the government and the potential effectiveness in actually attracting mobile workers. Each tax concession, whether in the form of a deduction or a credit or a rate-reduction or an omission from income, has a cost to government, namely, the amount of revenue foregone by the concession. Its effect on government revenue is the same as if the tax system lacked that particular concession, and the government made a direct expenditure of the cost of the concession to those persons who would have benefited from it. The effect of a tax concession is thus no different from that of an expenditure.[88] In addition to estimating cost of each tax incentive, the government should also ask whether the incentive will likely fulfill its objectives. Other measures, such as better training to integrate foreign-trained HSWs into the Canadian labour force, may be more effective.

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[86] This measure has been recently proposed in New Zealand. See M. Cullen, "Reducing Tax Barriers to International Recruitment to New Zealand" (Wellington, NZ: Inland Revenue Department, Policy Advice Division, 2003). Online: < http://www.taxpolicy.ird.govt.nz/publications/files/taxbarriersdd.pdf>.

[87] Harris, supra note 2; B.L. Lowell, "Policy Response to the International Mobility of Skilled Labour" (Geneva: ILO, 2002).

[88] The analogy to an expenditure was emphasized by Professor Stanley S. Surrey of Harvard Law School, who coined the term "tax expenditures" to describe tax preferences: Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973) and Surrey and McDaniel, *Tax Expenditures* (1985).

(3) Administering the tax incentives will undoubtedly be complex. Detailed rules are necessary to define: who is eligible for the incentives, what are the qualifying terms and conditions, how long is the incentive available, and how to prevent abuse.

(4) Being a member of the OECD, Canada should be careful in introducing any new tax measures that might be interpreted as "harmful" tax competition, because the OECD has been calling upon member countries to eliminate harmful tax practices.

7.2 Changes to Treaty Policy

To the extent that tax barriers arise from the lack of co-ordination of Canadian tax law and foreign tax laws, the best approach to reduce the barriers is through treaty negotiation. Canada has already achieved a great deal in its treaty negotiations with the United States in order to "integrate" domestic tax laws in certain areas, such as Article XIII(7) concerning the Canadian "departure tax" for US tax purposes, Article XVIII(7) concerning rollover of private pension plans; and Article XXI(5) with respect to charitable contributions. Article XXI(5) provides:

> "for purposes of the United States taxation, contributions by a citizen or resident of the United States to an organization which is a resident in Canada, which is generally exempt from Canadian tax and which could qualify in the United States to receive deductible contributions if it were a resident in the United States shall be treated as charitable contributions; however, such contributions … shall not be deductible in any taxable year to the extent they exceed an amount determined by applying the percentage limitations of the laws of the United States in respect of the deductibility of charitable contributions …

A corresponding provision in Article XXI(6) applies to contributions made by a Canadian resident to a United States charitable organization. Moreover, the Canada-United States Social

Security Agreement[89] provides for mutual recognition of public pension systems in terms of eligibility for benefits.

The Canada-US Tax Treaty is rather unique in its degree of "integration". Canada should incorporate replicate these existing provisions in other tax treaties. It is recognized that treaty negotiations are time consuming. Naturally, Canada needs to work on treaties that affect a large number of mobile workers. Empirical data and data published by Citizenship and Immigration Canada and Statistics Canada may provide some insights on what treaties are more urgent.

Moreover, the Canada-United States Treaty needs to be renegotiated to include a provision on employee stock options that can be modeled on a similar provision in the United States-United Kingdom treaty.[90] This provision could state that any benefits, income or gains received by employees under employee stock option plans constitute ''other similar remuneration'' and are taxed as employment income. It should also provide an allocation of taxing jurisdiction between the treaty countries over stock option plans if an employee:

- has been granted a share or stock option in the course of employment in one of the treaty countries;
- has exercised that employment in both treaty countries during the period between grant and exercise of the option;
- remains in that employment on the date of the exercise; and
- under the respective domestic laws of the treaty countries, would be taxable by both countries with respect to the gain on the option.

Finally, Canada should consider allowing reciprocal recognition of contributions to private pension plans in its treaty with the United States. The OECD suggested the following text for this purpose:

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[89] *The Agreement on Social Security between Canada and the United States,* signed on March 11, 1981, and amended by a supplementary agreement signed on May 10, 1983, and a second supplementary agreement signed on May 28, 1996.

[90] Treasury Department Technical Explanation of the Convention between the United States and Canada With Respect to Taxes on Income and Capital, Sept. 26, 1980 (entered into force Jan. 1, 1985) at Art. 14, para. 1.

1. Contributions to a pension scheme established in and recognized for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that state, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognized for tax purposes in that State, provided that:
   a. The individual was not a resident of that State, and was participating in the pension scheme, immediately before beginning to provide services in that State, and
   b. The pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognized as such for tax purposes by that State.
2. For the purposes of paragraph 1:
   a. The term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and
   b. A pension scheme is recognized for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."

8. CONCLUSIONS

International mobility of HSWs takes the form of permanent immigration or temporary relocation (including intra-company transfers). This paper analyzes the tax implications for both inbound mobility and outbound mobility from the perspective of Canada. Although tax rates have been considered a key factor in traditional tax literature on mobility, this paper focuses more on substantive tax issues related to residence and the determination of the tax base (e.g., the determination of employment income, employee stock option benefit, capital gains from the disposition of property, and contributions to and benefits from pension plans). Where relevant, the paper compares the Canadian tax treatment with that of the United States and China and examines the interaction of domestic tax laws through tax treaties.

The paper concludes that there are several potential tax barriers to international mobility of HSWs. These include: the uncertainty in establishing tax residence in Canada and the apparently severe consequences (such as double taxation and the imputed tax on foreign investment income earned from a foreign trust or corporation); double taxation resulting from the Canadian taxation on the "paper" gain under the departure tax; potential double taxation caused by the mismatch in the timing of the taxation event and characterization of the benefit from employee stock options; the lack of Canadian tax subsidies for retirement savings to HSWs moving across borders; and the potential compliance issues and substantive tax exposure for the employer of HSWs. Among the different groups of mobile workers, the tax barriers are more significant for temporary migrants and intra-company transfers.

The paper also concludes that the Canadian ITA is generally sound in its design and policy objectives. Equity, efficiency and international competitiveness should remain as the major policy goals for Canada. This paper does not recommend Canada to adopt special tax incentives in order to lure international HSWs to Canada or to lower the Canadian tax rates to that of the United States. The main goal in reform should be the removal of existing tax barriers to mobility. If free trade in goods and capital is sound economic policy, moving Canadian tax policy in the direction of promoting free movement of labour is also sound policy. The ITA can be amended by removing the tax barriers identified above. More importantly, Canada needs to work closely with its major trading partners through treaty negotiations. Three key areas that require immediate attention are the treatment of employee stock options, the coordination of the Canadian departure tax with the capital gains tax system of the other country, and the coordination of the treatment of pension contributions.

In terms of future research, more empirical study is warranted to establish the extent of the barrier to international mobility. In order to better assist Canadian policy makers to decide on the best reform options, it is also necessary to conduct a systematic and thorough analysis of the Canadian income tax system and pension system with respect to their impact on internationally mobile HSWs.

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