Canadian Taxation of International Mobile Workers: A Case for Reform

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CANADIAN TAXATION OF INTERNATIONAL MOBILE WORKERS: A CASE FOR REFORM

JINYAN LI

I. INTRODUCTION

Skilled workers are increasingly mobile across countries owing to the globalization of the economy and the development of international communications and transportation. International labour mobility is important to small, open economies such as that of Canada. To a great extent, Canada depends on the inflow of skilled workers and the retention of Canadian workers to obtain the supply of a labour force of sufficient size with the right mix of skills. This kind of labour force is important in order to build a more innovative and competitive economy. Canadian taxation of international labour income has not kept pace with changes in the labour force. Some key aspects of the current tax system, when applied to international mobile workers, lead to international double taxation, which arguably impedes international labour mobility. This Comment argues that it is time to review and reform Canadian tax policy in this area.

This Comment has four parts. Following this introduction, Part II provides an overview of the key aspects of Canadian taxation of international mobile workers. Part III makes the case for tax reform on the grounds that the existing rules potentially cause international double taxation of mobile workers, and that double taxation violates the policy objectives of equity and neutrality and potentially impedes international labour mobility. Part IV

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suggests changes to both domestic law and treaty law to prevent such international double taxation.

II. CANADIAN TAXATION OF INTERNATIONAL MOBILE WORKERS

Canadian taxation of international mobile workers is governed by the *Income Tax Act*¹ and tax treaties.² For the most part, the current system is sound in design and policy. However, when applied to international mobile workers, it is problematic in three areas: determination of residence, taxation of employee stock options, and tax treatment of deferred wages through pension plans.

A. RESIDENCE OF MOBILE WORKERS

A worker’s residency status in Canada determines the scope of his or her exposure to Canadian taxation. For Canadian residents, not only is foreign employment income subject to Canadian tax, but so is foreign investment income, which may include income imputed to the taxpayer by one of the extremely complex anti-avoidance rules.³ For non-residents, they are taxed only on their Canadian income.

In spite of its importance in Canadian tax law, the notion of “residence” is not defined in the *I.T.A.* Courts have held “residence” to be “a matter of the degree to which a person in

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³ *I.T.A.*, supra note 1, ss. 91-95 impute offshore passive investment income earned through a controlled foreign corporation, an offshore trust, or foreign investment entity to the Canadian resident. It is beyond the scope of this paper to discuss these rules. It is sufficient to state that these complex rules are designed to prevent Canadian residents from avoiding Canadian tax on their offshore investment income. For a discussion of the design and policy framework of these rules, see Jinyan Li, Arthur Cockfield & J. Scott Wilkie, *International Taxation in Canada: Principles and Practices* (Markham: Lexis-Butterworths, 2006) c. 12-14.
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.” 4 A number of factors are considered important in ascertaining whether “residence” has been established in Canada. These include owning a dwelling in Canada, having a spouse and/or dependent children that are situated in Canada, and social and economic ties with Canada. 5

With respect to individuals coming or leaving Canada, the I.T.A. provides two specific rules in order to provide more certainty. Subsection 250(1) is a bright-line test which deems a person to be a resident in Canada throughout the year if he or she sojourned in Canada in the year for 183 days or more. It typically applies to foreigners who come to Canada on a vacation or business trip. Subsection 250(3) provides that a person who was at the relevant time ordinarily resident in Canada is a resident in Canada. The effect of this rule is 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.

The determination of residence for Canadian tax purposes has three important implications for mobile workers:

1. When individuals leave Canada to work in a foreign country (i.e. outbound workers), they may still be considered to be “ordinarily resident” in Canada during the entire period of the physical absence from Canada. 6

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5 These factors are summarized in IT-221R3, ibid.
6 In Gaudreau v. The Queen, 2004 TCC 840, 2005 D.T.C. 66, [2005] 1 C.T.C. 2701 (T.C.C), aff’d 2005 FCA 388, 2005 D.T.C. 5702 (Eng.), [2006] 1 C.T.C. 137, 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 an RRSP, credit cards and safety deposit box.
meantime, an outbound worker may be found to be a resident in the foreign host country. Such a dual-residency problem may also exist in the case of inbound workers: A foreign worker who comes to work in Canada may be treated as a Canadian resident under either the common law test or the subsection 250(1) deeming rule. The dual-residency problem can only be addressed by the tie-breaker rules in a tax treaty. If the foreign country has no treaty with Canada, the worker’s total worldwide income may be taxed in both Canada and the other country.

2. Inbound workers who acquire Canadian residence are exposed to Canadian taxation with respect to their employment income, as well as investment income. Any investment in offshore investment entities (such as trusts and mutual funds) is potentially taxable in Canada, whether or not any income is actually earned. The anti-deferral rules in the I.T.A. simply impute an amount of income to the taxpayer on an annual basis. If the inbound worker is well-advised on tax planning, he or she can avoid these rules by using an “immigrant trust”.

3. Acquiring or abandoning Canadian residence may give rise to another Canadian tax issue – a deemed disposition and
reacquisition of capital assets for fair market value immediately before the change of residence. For an outbound worker, this rule triggers Canadian taxation of capital gains accrued to the assets, which is why this rule is nick-named the “departure tax”. This rule was intended to protect the Canadian tax base by taxing all capital gains accrued during the taxpayer’s Canadian residency. However, because it is a tax on “paper” gains, it creates problems of liquidity and double taxation. The taxpayer may not have sufficient cash to pay the tax. The paper gain may be taxed again in the foreign country when the property is actually sold, thus causing international double taxation. Relief from such double taxation is rarely available under the domestic tax law of a foreign country or under a tax treaty. For inbound workers, section 128.1

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10 I.T.A., supra note 1, s. 128.1. 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 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 protected. For emigrants, excluded properties include real property situated in Canada, employment-related stock options and certain pension and similar rights. Technically, s. 128.1(4) deems a taxpayer who has ceased to be a Canadian resident to have disposed of 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.

11 The I.T.A. provides some relief. For example, the taxpayer has the option of providing adequate “security” in lieu of tax payment or defer the payment of tax on emigration [ss. 220(4.5)-(4.54)] or elect that certain capital property owned by the individual not be subject to a deemed disposition [s. 128.1(4)(d)].

12 For example, under the domestic tax laws of the United States, the “departure tax” is not recognized as a real tax. So, when X in the example sells the shares in 2006 for $110,000, under the U.S. 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.

13 Article XIII of the 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, Canada and the United Kingdom, 8 September 1978, Can. T.S. 1980 No. 25 provides such relief. It allows the computation of the U.S. gain to be based on the fair market value of the property on the date of departure (i.e., $90,000 in the example described in the previous note). Most Canadian treaties do not contain this rule.
ensures that capital gains accrued prior to becoming Canadian residents are tax-free in Canada. However, if the worker leaves Canada for a short period of time, he or she is subject to the above-mentioned departure tax. Subsection 128.1(4) of the I.T.A. provides some relief to short-term residents by excluding from tax properties brought to Canada at the time of immigration and properties acquired by inheritance or bequest after becoming a Canadian resident.

B. TAXATION OF EMPLOYEE STOCK OPTIONS

Employee stock options are often an important component of compensation for workers, especially highly-skilled employees who tend to move internationally. Under section 7 of the I.T.A., a stock option, like any other property given to an employee as compensation, is taxable as employment income when

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14 Under s. 128.1(1), an individual is deemed to have disposed of each property immediately before becoming a Canadian resident and reacquired the same property at a cost equal to the fair market value of the property at that time.
15 A short-term resident is someone who, during the 10 preceding years, was a resident in Canada for no longer than 60 months: I.T.A., supra note 1, s. 128.1(4)(b)(v). Examples are employees of international firms, who migrate to and work in Canada for short periods of time and immigrants who return to their original country.
16 Income from employment typically includes wages, salaries and other similar remuneration, taxable fringe benefits, as well as benefits from employee stock options. There are very limited deductions in computing income so that employment income is largely taxable on a gross basis: I.T.A., supra note 1, s. 8. Section 122.3 of the I.T.A. provides a special tax credit to individuals who work 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. The amount of income eligible for the credit is $80,000 per year.
18 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
received\textsuperscript{19} by the employee. The employee is taxed on the difference between the option price and the fair market value of the stock.\textsuperscript{20} Where an option holder has ceased to be an employee before exercising the option, section 7(4) deems the employment to continue to exist.

For cross-border mobile workers, the taxation of employee stock options raises several unique issues, mostly because of the inconsistent rules between Canada and other countries. Inconsistency often exists with respect to: the timing of taxation—national tax rules run the gamut from taxation upon grant, lapse of vesting, exercise, or the ultimate sale of the underlying stock;\textsuperscript{21} the characterization of the benefit as employment income or a capital gain; and the territorial source of the benefit.\textsuperscript{22} This may result in double (or multiple) taxation of the mobile worker. For example, in \textit{Tedmon v. M.N.R.},\textsuperscript{23} the taxpayer was an American

\textsuperscript{19} The timing of taxation for employee stock option benefits is generally when the option is exercised and shares are 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 stock 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.

\textsuperscript{20} For example, where an employee purchases shares worth $100,000 for $20,000 pursuant to an employee stock option plan, the employee’s taxable benefit is $80,000.

\textsuperscript{21} For example, the option is taxable when the right is vested in Belgium, when the option is exercised in Canada and U.S. (in certain circumstances), or when the share bought under the option is sold in Canada (CCPC shares) and the U.S. (in respect of “incentive stock options”). For some discussion of Canadian rules, see Bruce Sprague & Michael Hayward, “The Taxation of U.S. Employees in Canada” (2004) 52 Can. Tax J. 192 at 192.

\textsuperscript{22} The source rule can be based on the place of employment when the stock option was granted, the current place of employment, or the residence of the worker.

citizen who was granted the option to purchase the stock of General Electric, his employer in the United States (U.S.), 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. A portion of the benefit attributable to services rendered in the United States would be considered U.S. source income and subject to U.S. tax.²⁴

C. PENSIONS²⁵

Pensions represent deferred wages or salaries. Membership in an occupational pension plan is an important form of compensation. Canada, like many other countries, provides tax subsidies to registered pension plans (RPPs)²⁶ and registered retirement


²⁵ 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. 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 system, including the employer-sponsored registered pension plan (RPP) and individually-based registered retirement savings plans (RRSPs). For a more recent debate about pensions and retirement issues, see Leroy O. Stone, ed., New Frontiers of Research about Retirement and Other Later-Life Transition (Ottawa, Canada: Statistics Canada and Institut de la Statistique Quebec, 2006).

²⁶ 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 I.T.A. supra note 1, s. 147.1. They are the most important type of private pension plans in terms of assets accumulation and
savings plans (RRSPs). There is a universal limit for the maximum amount of tax-deductible contributions to all types of tax-assisted pension plans: 18 percent of the previous year’s earned income up to the specified dollar amount ($15,500 in 2005). Contributions to these plans are generally limited to Canadian resident workers. To qualify for the tax subsidy, the pension plan must be approved by the Minister of National Revenue. The tax subsidy to pension plans in other countries more or less mirrors the Canadian system in that it is available only to domestically-registered pension plans covering domestic workers.

When workers move between countries, there are significant issues arising from the lack of interaction between national laws. Tax treaties do not provide adequate coordination between national taxation of pension plans. Cross-border issues generally include: 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 transferability of pension interest from Canadian plans to foreign plans, and vice versa.

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27 An RRSP is a registered retirement savings plan set up by individuals that qualify for the deductions under s. 146 of the I.T.A. 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.

28 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.

29 Another potential issue is the allocation of tax jurisdiction over pension benefits paid by a pension plan to a person living in a foreign country. Pension benefits are generally payable after retirement. With respect to outbound workers, pension benefits paid out of Canadian plans are taxable at 25 percent of gross payments: I.T.A., supra note 1, s. 212(1)(h) (RPP benefits), 212(1)(l) (RRSP payments), and 212(1)(j) (RCA payments). A non-resident can elect under s. 217 of the I.T.A. to pay tax on a net basis at progressive rates, as opposed to the 25 percent withholding tax on gross amounts. Many Canadian tax treaties reduce the tax rate for pension payments to 15 percent, see e.g. Convention Between Canada and the United States of America with respect to
With respect to contributions to pension plans, the case is relatively straightforward for outbound workers—so long as a mobile worker retains his or her Canadian residence and files a tax return, tax-deductible contributions can be made. Contributions to RPPs are more complex. Paragraph 8503(3)(a) of the Income Tax Regulations\(^3\) 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. If the individual is taxable in the host country on his or her employment income, the value of the RPP contributions made on his or her behalf is likely taxable as an employment benefit. For inbound workers, contributions to their new Canadian employer’s RPP are generally not a serious problem. RRSP contributions are tied to the previous year’s earned income and the worker must become a Canadian resident.\(^3\) As such, no RRSP contribution can be made during the first year in Canada. If an inbound worker wishes to remain covered by a foreign plan (as in the case of intra-company transfers), a Canadian tax subsidy is not available. The foreign plan generally does not qualify as an RPP; contributions made by the worker to the foreign plan are not tax deductible, and the value of contributions made by the employer is generally a taxable benefit to the worker.\(^3\) However, there is a five-year window of

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\(^{3}\) Taxes on Income and on Capital, 26 September 1980, Can. T.S. 1984 No. 15, art. XVIII [Canada-U.S. Treaty].

\(^{30}\) Income Tax Regulations, C.R.C., c. 945.

\(^{31}\) See I.T.A., supra note 1, s.146(1), definition of “RRSP deduction limit”.

\(^{32}\) 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). An 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. Employer contributions are tax 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
time during which the employer’s contribution to the foreign plan generally does not give rise to a taxable benefit to the employee, but it may reduce the employee’s contribution room for the RRSP.\footnote{33} An exception applies to U.S. Individual Retirement Accounts (IRAs),\footnote{34} contributions of which do not give rise to a

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\footnotetext[33]{All foreign pension plans are generally EBPs for the first 60 months that the employee is a resident of Canada, and then RCAs.}

\footnotetext[34]{An 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. The taxation of income earned in the IRA is deferred until the income is distributed. As part of the \textit{Taxpayer Relief Act of 1997}, Pub. L. No. 105-34, 111 Stat. 788, 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 accures on a tax-free basis and distributions are generally not taxable: I.R.C. §§ 408A(c)-(d) (2007).}
taxable benefit to an American worker in Canada and the income accumulated in the plan is not taxable in Canada.\textsuperscript{35}

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.\textsuperscript{36} In its application to Canada, such a provision typically provides for the following conditions: the contributions are paid by, or on behalf of, an individual who is resident or temporarily resident in Canada; the contributions are paid to a pension plan that is recognized for tax purposes in the other treaty country; and the contributions are made in a year in respect of services rendered in that year. This provision is found in some Canadian treaties, such as the one with Chile, Estonia, France, Latvia, Lithuania, the Netherlands, South Africa, Sweden, and Switzerland.

While transfers among Canadian RPPs and RRSPs may be tax-free, such treatment is generally not available to transfers of funds between a foreign plan and a Canadian plan.\textsuperscript{37} A limited cross-border rollover is provided for Canada-U.S. mobile workers. American workers coming to work in Canada may rollover their U.S. 401(k) plans\textsuperscript{38} and IRAs into Canadian RRSPs.\textsuperscript{39} If an

\textsuperscript{35} For Canadian tax purposes, an IRA qualifies as a “foreign retirement arrangement” under s. 6803 of the Income Tax Regulations, supra note 30. As such, there will be no immediate tax consequences with respect to contributions the U.S. plan and the income earned in the plan while the individual is a Canadian resident.


\textsuperscript{37} For example, s. 147.3 allows direct transfers from an RPP to an RPP or RRSP and s. 147(16) allows transfers from an RRSP to an RPP, another RRSP.

\textsuperscript{38} A 401(k) plan is named after the section of the Internal Revenue Code, supra note 34, 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), the transfer reduces the employee’s salary. The annual employer transfer is limited. Unlike defined contribution plans, the employer participating in defined benefit
individual prefers to retain the U.S. plans, Article XVIII(7) of the Canada-U.S. Tax Treaty allows him or her to defer the Canadian taxation of income accruing in the U.S. plan. However, this rollover is one-sided. For Canadians moving south, the United States does not provide a similar rollover for Canadian RRSPs. Therefore, a transfer of Canadian RRSPs to a U.S. plan would be considered a distribution under Canadian law, and would trigger taxation in both countries. If these individuals leave the RRSP intact, the earnings of RRSPs are currently taxable in the U.S., unless the worker elects under XVIII(7) of the Canada-U.S. Treaty to defer the U.S. taxation.

D. INTERNATIONAL DOUBLE TAXATION

The above analysis of the Canadian taxation of international mobile workers reveals several causes of international double taxation. One cause is dual residence of a mobile worker, which leads to the taxation of the worker’s worldwide income in Canada and another country. When temporary mobile workers and intra-pension plans contributes the necessary funds in order to provide a definite amount upon retirement. The differing types of defined benefit plans correspond to the method of determining the participants’ benefit. For instance, a “flat benefit plan” reflects a percentage of the employee’s compensation while a “unit benefit plan” corresponds to the number of years in service with the employer.

For U.S. tax purposes, the U.S. plan is collapsed and amount withdrawn is subject to a U.S. withholding tax at 15 percent (as reduced by the Canada-U.S. Treaty, supra note 29, art. XXII). For Canadian tax purposes, the withdrawal amount is included as income, but a deduction under s. 60(j) of the ITA, supra note 1, for the amount transferred to an RRSP can offset the income inclusion.

Supra note 29.

Ibid. 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 U.S. 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.

Double taxation caused by dual residency may be reduced by tax treaties, but such relief is not available to workers coming from a jurisdiction that has no treaty with Canada.
company transferees are physically present in Canada for a short period of time, they may be taxed as Canadian residents under the common law facts-and-circumstances test or the bright-line test under subsection 250(1)(a) of the I.T.A. 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 their offshore investments may be subject to Canadian tax\(^4^3\) even if no income is paid. The tax relief for immigrant trusts is helpful only if the inbound worker is aware of it and actually takes advantage of it.

Another cause of international double taxation is the departure tax. Because Canadian tax is generally imposed on gains when the property is sold, this tax on paper gains 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.\(^4^4\)

A third cause of double taxation is the mismatch of domestic rules in Canada and another country. This is particularly a problem in the case of employee stock options and pensions. There could be multiple taxation of the same stock option benefit if the taxpayer has moved among several countries. Canadian tax treaties do not specifically address the treatment of stock options. Double taxation may arise from the taxation of contributions to pension plans, the transferability of pension entitlement between Canadian and foreign plans, and the taxation of pension benefits.

III. THE CASE FOR REFORM

Tax reform is necessary because the current system results in international double taxation of mobile workers, which not only violates tax policy objectives of equity and neutrality, but also impedes Canada’s efforts in building an innovative economy. It is argued below that the current tax policy is based on outdated assumptions about the Canadian labour force and that it is time to

\(^{4^3}\) See supra note 3 and accompanying text.

\(^{4^4}\) 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 and has not been able to include a relief measure in most treaties.
re-examine the policy in light of recent trends in international labour mobility.

A. NEGATIVE POLICY IMPLICATIONS

Any form of international double taxation inherently impedes the international flow of capital. As early as the 1920s, the League of Nations identified the prevention of double taxation as a key objective for international tax policy.\textsuperscript{45} Canadian tax policy has strived to avoid international double taxation through domestic tax measures (such as foreign tax credit) and treaty measures\textsuperscript{46} and has been effective in eliminating double taxation in the case of mobile capital. However, labour has not been considered mobile until recently.

From the perspective of equity, it is simply inequitable to have the income of international mobile workers taxed in both Canada and a foreign country. It also violates the principle of tax neutrality and efficiency. Ideally, taxes should be neutral and should “bring about a minimum change in the allocation of resources within the private sector of the economy”.\textsuperscript{47} In a neutral tax system, a person’s decision to move across countries would be no different than if he or she 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 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. This seems to be the case in the taxation of international mobile workers.

International double taxation of mobile workers potentially impedes workers from moving across borders, and thus minimizes Canada’s competitiveness in attracting mobile workers to Canada.

\textsuperscript{45} For an overview of the history of the international tax treaty system, see Jinyan Li, \textit{International Taxation in the Age of Electronic Commerce: A Comparative Study} (Toronto: Canadian Tax Foundation, 2003) c. 2.

\textsuperscript{46} See Li, Cockfield & Wilkie, \textit{supra} note 3, c. 10-11.

The Canadian government recognizes the importance of international mobile workers to the Canadian economy and has organized studies on possible barriers to such mobility.\(^{48}\) One study\(^{49}\) finds that labour cost is a primary obstacle to intra-company transfers and the most significant cost-related obstacles include employee compensation and taxation.\(^{50}\) International empirical studies\(^{51}\) find tax policy as a relevant factor to the


\(^{50}\) As Lopes, ibid., explains: “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.” 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 such as accommodation allowances also increase mobility costs.

\(^{51}\) See PricewaterhouseCoopers, “Managing Mobility Matters—a European Perspective” (2002), online: PricewaterhouseCoopers <http://www.pwc.com/gx/eng/ins-sol/spec-int/eeo/whtpap14_02.pdf>. This study 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 of the European Union. Another study, PricewaterhouseCoopers, “International Taxation of Expatriates”, supra note 17, found that the taxation of labour income and the possibility of double taxation on pensions from occupational pension plans are major obstacles for international assignment. See also the Organisation for Economic Co-operation and Development [OECD], Tax Treaty Issues Arising from Cross-Border Pensions, Public Discussion Draft (2003), online: OECD <http://www.oecd.org/dataoecd/24/40/19239649.pdf> and OECD, “OECD Recommends Common Tax-Treaty Approaches to Employee Stock-Options” (9 March 2004), online: <http://www.oecd.org/document/58/0,2340,en_2649_201185_33700026_1_1_1_1,00.html>.
mobility of workers and the location decision about foreign direct investment.\footnote{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”, online: OECD <www.oecd.org/dataoecd/35/6/2100652.pdf>.}

B. OUTDATED ASSUMPTIONS

Double taxation of mobile workers under current Canadian law and international treaties can be attributed in part to the outdated assumption that workers were immobile and tax policy could stem the brain drain.

Recent literature indicates that the Canadian labour force is increasingly more mobile across borders, which is particularly true in the case of skilled workers.\footnote{For a survey of the literature, see Benoit Dostie and Pierre Thomas Leger, “A Critical Review of the Microeconomic Migration Literature”, Working Paper D-05 (2004) in HRSDC-SSHRC Skills Research Initiative Working Paper Series, \textit{supra} note 48.} This is part of a recent trend. 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 skilled workers.\footnote{In Surendra Gera, Samuel A. Laryea, & Thitima Songsahul, \textit{International Mobility of Skilled Labour: Analytical and Empirical Issues, and Research Priorities} (Ottawa: Government of Canada, 2004) at 7, “highly skilled workers” are defined to include “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.” They are thus generally highly-educated and arguably have high productivity: Assaf Razin & E. Sadka, “Capital Income Taxation in the Globalized World”, online: National Bureau of Economic Research <http://www.nber.org/papers/w10630> at 3.} In fact, skilled workers are one of, if not the most, important internationally mobile resources.\footnote{Keith Head & John C. Ries, \textit{Can Small-Country Manufacturing Survive Trade Liberalization?: Evidence from the Canada-U.S. Free Trade Agreement} (Ottawa: Industry Canada, 1999).} Canada is a major recipient of immigrant workers from the rest of the world and temporary workers from the United States, Mexico, and the
United Kingdom. In the meantime, Canada is a main sending country of workers to the United States.\textsuperscript{56} As compared with permanent migration, more and more skilled workers move on a short-term or temporary basis (often on intra-company transfers).\textsuperscript{57}

Canadian tax policy seems to have been preoccupied by the concern about brain drain to the United States.\textsuperscript{58} This concern apparently influenced the introduction of the "departure tax",


\textsuperscript{57} The driving forces 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. Differences in labour market conditions and increased income and employment opportunities are also relevant factors. With respect to intra-company transfers of workers, 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 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.

among other rules of the I.T.A.\textsuperscript{59} It reflects an outdated model of labour mobility.\textsuperscript{60} A more recent, global perspective on mobility\textsuperscript{61} views international labour mobility as a brain exchange, brain circulation, or part of the globalization of a highly skilled labour market. It suggests two-way flows of knowledge, ideas and technology among trading countries. Proponents of this perspective maintain that the international mobility of skilled workers can generate global benefits by improving knowledge flows and satisfying the demand for skilled workers 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 countries participating in that labour exchange.”\textsuperscript{62} For example, the Organisation for Economic Co-operation and Development (OECD) estimates that 15 percent of high-income earning Canadian migrants in the United States return to Canada after five years and 20 percent return after 10 years, and that such mobility of skilled workers could improve knowledge flows and spillovers.\textsuperscript{63} Similarly, there are substantial outflows of previous Canadian immigrants as part of the rising phenomenon of brain circulation.\textsuperscript{64} As mentioned above, temporary migration (both

\begin{itemize}
  \item The introduction of the tax deferral for stock options was intended to stem the brain drain to the U.S. See Daniel Sandler, “The Tax Treatment of Employee Stock Options: Generous to a Fault” (2001) 49 Can. Tax J. 259.
  \item The traditional migration literature treats labour as fairly homogeneous and the net out-migration of skilled workers as a “brain drain”. See Surendra Gera, Samuel A. Laryea, & Thitima Songsahul, \textit{supra} note 54.
  \item \textit{Ibid.} at 5.
  \item D. Schwanen, \textit{supra} note 58 at 17.
inbound and outbound) is becoming more important in recent years.\textsuperscript{65}

The brain circulation perspective is consistent with the economic theory underlying international free trade and economic globalization. As with free movement of other forms of capital, knowledge flows are found to enhance firm productivity and economic growth.\textsuperscript{66} There is empirical evidence that international labour mobility influences knowledge flow patterns and that both the sending country and the receiving country benefit from the mobility of knowledgeable workers.\textsuperscript{67} Moreover, economic growth is strongly correlated with foreign direct investment. The location decision of foreign direct investment is in part affected by the research and development capacity and the availability of skilled professionals.\textsuperscript{68}

When the I.T.A. was first introduced in 1917, the Canadian labour force was more or less immobile. More recent amendments have attempted to address the mobility issue. For example, section 128.1(4) of the I.T.A. provides for an exception to the departure tax for individuals who move to Canada for a period of less than 5 years; subsection 94(1)(b)(i)(A)(III) of the I.T.A. provides for a 5-year non-taxability of income earned through an offshore trust established for new immigrants; section 6803 of the Income Tax Regulations\textsuperscript{69} recognizes foreign pension plans for limited purposes; and subsection 60(1)(j) of the I.T.A. permits rollover of U.S. IRAs to Canadian RRSPs. However, these changes fall short of unilaterally preventing double taxation of mobile workers. The lack of “modernization” in treaty law in order to recognize the

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\textsuperscript{65} Surendra Gera, Samuel A. Laryea & Thitima Songsahul, \textit{supra} note 54.


\textsuperscript{67} \textit{Ibid.}


\textsuperscript{69} \textit{Supra} note 30.
fact that workers are increasingly mobile also contributes to the problem of double taxation.

C. TIME FOR RETHINKING

With a relatively small and open economy, Canada has long realized the benefit of free trade and is an active member of the World Trade Organization, the North America Free Trade Agreement, the Organisation for Economic Co-operation and Development, and the Asia Pacific Economic Cooperation. Canadian international tax policy has aimed at promoting international trade and investment by eliminating double taxation. More specifically, Canada recognizes that capital is mobile and a competitive tax policy is crucial to attracting mobile capital to Canada. The design of Canadian international tax policy largely reflects not only capital export neutrality but also capital import neutrality.

Until recently, the most sought after internationally mobile resource has been foreign direct investment, particularly new manufacturing facilities of multinational enterprises. As mentioned above, in recent years, knowledge and human capital are increasingly mobile. Such increased international labour mobility calls for some serious rethinking about the current tax policy regarding mobile workers. Double taxation or erecting tax barriers to mobility is certainly unhelpful to promoting mobility. Tax reforms to remove such barriers could prove to be quite important for Canadian economic growth in the long term.

Therefore, even though the impact of double taxation on mobile workers could be ignored in the past, it is no longer the case today. Reforms to both domestic law and treaty law are necessary to remove such double taxation.

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70 For a more detailed discussion of the design of Canadian international tax system, see Li, Cockfield & Wilkie, supra note 3, c. 2.

71 See Richard G. Harris, “Labour Mobility and the Global Competition for Skills: Dilemmas and Options”, Working Paper D-02 (2004) in HRSDC-IC-SSHRC Skills Research Initiative Working Paper Series, supra note 48 (noting that while “small countries may be potential losers in a non-cooperative global skills competition with race to the bottom type outcomes” they stand to benefit from an integrated labour market within free trade areas).
IV. REFORM OPTIONS

A. CHANGES TO DOMESTIC LAW

Domestic reform should aim at reflecting the global brain circulation or brain exchange perspective of labour mobility. An apparently simple, but technically complex, approach to reducing international double taxation of mobile workers through domestic reforms is to redesign the "5-year rule" which is currently scattered in various provisions of the *I.T.A.*: such as the "departure tax" rule under subsection 128.4(b)(iv), the offshore trust rule under subsection 94(1), and the foreign pension plan rules under subsection 207.6(5.1). These rules recognize the fact that individuals who move to Canada for a short period of time should not be taxed as permanent residents. This implicit short-term resident taxation idea can be codified into an explicit rule. An explicit 5-year rule could be introduced to: permit short-term residents to be taxed, in essence, only on their income from employment or business and foreign investment income repatriated to Canada; exempt short-term residents from the departure tax; make the current immigrant trust exemption available to all inbound short-term workers; and continue with the employee benefit plan rules.

Such an explicit five-year rule would help remove international double taxation of mobile workers. During the first five years of residence in Canada, foreign investment income would not be taxable in Canada. Therefore, even if a worker has dual residency, international double taxation of investment income is avoided. Potential double taxation of the paper gain under the departure tax would be prevented if the worker leaves

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72 Under this rule, properties brought into Canada or inherited during residence in Canada are exempted from the departure tax if the taxpayer was not a resident in Canada for more than five years during a 10-year period prior to the departure.

73 This provision effectively provides that a non-resident trust is free from s. 94 (offshore trust rules) within the first 60 months of Canadian residency of the person contributing to the trust.

74 This provision effectively allows the foreign plan to be taxed as an employee benefit plan during the first 5-year residence of an inbound worker.
within the 5-year period. It would make the current "immigrant trust exemption" available to all inbound workers, thereby putting all inbound workers on the same footing whether or not they are well advised by tax professionals. Overall, the explicit 5-year rule would improve certainty and fairness of the Canadian tax system for mobile workers.

B. CHANGES TO TREATY LAW

Changes to treaty law require renegotiation of tax treaties with countries that are the sending or receiving countries of Canadian mobile workers. The major treaty is, of course, the Canada-U.S. Treaty. Potential international double taxation of employee stock options can be addressed more effectively through international coordination of domestic rules. The same is true with pensions. 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 U.S. tax purposes, Article XVIII(7) concerning rollover of private pension plans, and Article XXI(5) with respect to charitable contributions. Canada should consider replicating these existing provisions in other treaties.

Furthermore, the Canada-U.S. Treaty could be renegotiated to include a provision on employee stock options to allocate the jurisdiction to tax the benefit from such options. The United States has already included a provision on employee stock options

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in its treaty with the United Kingdom.\textsuperscript{77} Article 14 of this treaty provides a specific rule for allocating the taxing rights where: (a) an employee has been granted a stock or share option in the course of employment in one of the Contracting States, (b) he or she has exercised that employment in both States during the period between grant and exercise of the option, (c) he or she remains in that employment at the date of the exercise, and (d) under the domestic law of the Contracting States, he or she would be taxable by both Contracting States in respect of the option gain. In this situation, each Contracting State may tax as State of source only that portion of the option gain which relates to the period or periods between the grant and the exercise of the option during which the individual has exercised the employment in that Contracting State. The portion attributable to a Contracting State will be determined by multiplying the gain by a fraction, the numerator of which is the number of days during which the employee exercised his employment in that State and the denominator of which will be the total number of days between grant and exercise of the option. The competent authorities of the Contracting States will endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of Article 14 and Article 24 (Relief from Double Taxation) in relation to employee stock or share option plans.

Finally, Canada should consider allowing reciprocal recognition of contributions to private pension plans in its treaty with the United States that can be based on the following proposal by the OECD:

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. 78

V. CONCLUSIONS

This Comment reaches several main conclusions. First of all, the current Canadian taxation of international mobile workers causes international double taxation in respect of the determination of residence and the tax treatment of employee stock options and pension plans. Secondly, double taxation is not only unfair to mobile workers, but it also potentially impedes Canada’s efforts in attracting and retaining skilled workers. Thirdly, it is time for Canada to revisit the assumptions and policy rationale underlying the current tax system and to “modernize” its tax policy in order to reflect the fact that workers are increasingly internationally mobile. As an open economy, Canada stands to gain from international labour mobility. In the absence of any comprehensive empirical data on the extent of tax impediments to international labour mobility, this Comment makes the case for

tax reform on a normative basis. Before undertaking any reform measures, however, it would be helpful to have a more systematic and thorough analysis of the impact of tax policy on internationally mobile workers.