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Temporary assignment of an employee from Canada to the United States

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This article is the fourth and final part in a series examining the Canadian and U.S. income tax implications of the temporary assignment of an employee from Canada to the U.S. Specifically, these articles address the situation of an employee remaining employed by a Canadian entity, but temporarily assigned to work in the U.S. Our previous articles (the Winter, Spring and Summer 2015 U.S. Tax Alerts) examined the importance of the determination of “residency” for personal income tax purposes, the Canadian and U.S personal tax liabilities based on different residency scenarios and the concept of “tax equalization.” This article examines select corporate payroll issues associated with a short-term assignment.

**Canadian payroll**

Employees sent on temporary assignments (generally not greater than five years) from Canada to the U.S. generally remain on their Canadian payrolls. Where such an employee remains a resident of Canada, the Canadian entity is required to continue withholding Canadian federal and provincial payroll taxes on all of the employee’s earnings, even those related to services rendered outside of Canada. Since the employee will be eligible to claim a credit in Canada for the taxes paid in the U.S. – to avoid the hardship of remitting tax in two countries – a tax deduction waiver application may be filed with the Canada Revenue Agency to reduce the Canadian withholding requirement.

The waiver permits the employer to reduce the Canadian income tax withholding at source to reflect the fact that the Canadian tax on the U.S. source wages should be offset with a foreign tax credit in Canada. CRA Form T1213 is used for this purpose. It is accompanied by an estimated tax calculation that shows the expected foreign tax credit for taxes paid in the U.S. and the net estimated Canadian tax liability on the U.S. source income.

Once the CRA approves the application, the employee must provide the approved waiver to the employer. At this point, and only on a prospective basis, the employer may reduce the actual Canadian tax withholdings to reflect the net estimated Canadian tax liability on the U.S. source income. If the waiver approach is used, we recommend that the Canadian entity implement a hypothetical income tax withholding system to ensure that the employee continues to pay a hypothetical Canadian tax based on the compensation elements for which the employee is still responsible. (This concept was addressed in the Summer 2015 U.S. Tax Alert.)

Ultimately, the combination of the waiver and the hypothetical tax withholdings provides a useful solution to what would otherwise be a cash flow issue for the company and/or the employee. Specifically, this process allows the employee to continue to fund tax at the same or a similar level as they did prior to the foreign assignment. It also allows the company the discretion to use the hypothetical withholdings to assist in funding the U.S. and state tax withholdings under the U.S. payroll requirements.

**Canada Pension Plan (CPP) implications**

Employees on temporary assignments from Canada to the U.S. may qualify for an exemption from U.S. social security and may be able to continue contributing to the Canadian social security system under the social security Totalization Agreement between Canada and the U.S. The exemption also applies to the employer’s mandatory social security contributions. To obtain the exemption,
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the company must apply to the CRA for a “certificate of coverage” using Form CPT56.

Quebec is the only province that has its own pension system, called the Quebec Pension Plan (QPP). QPP regulations permit voluntary contributions to the plan while employees are working outside of Canada on a temporary basis, provided specific criteria are met.

Employment Insurance (EI) implications

EI regulations also permit continued contributions while employees are working outside of Canada on a temporary basis. Under subsection 5, an employment outside Canada is insurable when all of the following conditions are met:

1. the employed person ordinarily resides in Canada;
2. the employment takes place outside Canada, or partly outside Canada for an employer who is resident or has a place of business in Canada;
3. the employment would be insurable if it were in Canada; and
4. the employment is not insurable under the laws of the country in which it takes place.

Quebec Parental Insurance Plan (QPIP) implications

Quebec employees must cease contributions to QPIP the moment they become non-residents of Canada. In order to be eligible to receive QPIP benefits, the beneficiary must be a tax resident of Canada at the time the claim is made. An individual could also be eligible for QPIP benefits if they were a resident of Canada at the beginning of the period in which they started receiving benefits, and became a non-resident afterwards.

Employer Health Tax (EHT) implications

For Ontario employees, EHT premiums are generally still required, even when the employee is assigned temporarily outside of the country. The amount of tax payable by an employer for a year is equal to the total taxable Ontario remuneration paid by the employer during the year multiplied by a rate determined by the employer’s total taxable Ontario payroll.

Penalties and interest

The CRA may impose several different penalties when an employer fails to properly address its Canadian payroll requirements. The imposition of such penalties (and related interest) is subject to various conditions and the facts of each case.

U.S. payroll – shadow payroll

A Canadian employee assigned temporarily to the U.S. will generally remain on the Canadian payroll (discussed above). However, U.S. payroll reporting and withholding obligations are also imposed on the employer. It is a question of fact whether an individual is considered an employee of the U.S. entity or the Canadian entity while working in the U.S. It is possible for an employee to have two employers, and the employer analysis cannot be based solely on the concept of a “legal” employer. Ultimately, the employer “in fact” is responsible for the U.S. payroll compliance. For this reason, it may be desirable to ensure that a proper secondment agreement is put in place prior to the employee’s assignment to limit the exposure of the
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Canadian entity to various U.S. corporate tax issues, including the requirement to comply with U.S. payroll obligations.

U.S. employers are required to withhold income tax, Social Security, Medicare and state tax (if applicable) for each employee rendering services in the U.S. The employer is required to use the graduated rates and must remit the withholdings by the prescribed dates set out by the IRS. In essence, a U.S. shadow payroll is run in the same way as any domestic U.S. payroll, with the exception that no cash is actually delivered through the U.S. payroll to the employee.

Reporting requirements

Employers must prepare and file Form W-2 in order to report amounts paid to their employees regardless of where the remuneration is earned. Form W-2 must be filed, reporting total compensation paid to the employee, as well as the total U.S. federal income tax, Social Security, Medicare and state tax withholdings. The form must be given to the employee no later than January 31 following the applicable tax year, and it must be filed with the IRS by the last day of February of the year following the year in which compensation was paid.

The employer is required to report the amount of taxes withheld on the payroll tax return (Form 941). This return and a payment of employment taxes is due every calendar quarter.

Penalties

The IRS may impose several different penalties when an employer fails or is late in filing a required payroll return, paying a tax or making required deposits of taxes. Penalties (and related interest) are subject to conditions and the facts of each case.

The complexities associated with a temporary cross-border employee assignment extend well beyond personal tax matters and into corporate payroll issues in both Canada and the U.S. There are also corporate income tax matters, including transfer pricing, that must be considered. Though it may be imperative to a business for a key employee to undertake an international assignment, this series of articles should serve as a reminder that several income tax issues must be addressed to ensure the assignment is a success.

Contact your Collins Barrow advisor for further assistance.

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