THE CANADIAN

TAX GUIDE

FOR RESIDENTS AND NON-RESIDENTS

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Published by Live and Invest Overseas™
Dr. Alberto Navarro Street, El Cangrejo,
Panama City, Republic of Panama

Publisher: Kathleen Peddicord

www.liveandinvestoverseas.com

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CHAPTER I

Introduction

Canadian investors are among the most internationally-aware residents in the world. This is due to a variety of reasons. One is the proximity of Canada to the United States, the world's economic engine for many decades. Canadian exports to and imports from the United States represent a very large and significant contribution to Canada's GDP. Canadian businessmen and investors keep tabs on what happens in the United States and how it may affect their economic and financial affairs.

Another reason is that, given a relatively small population of about 42 million, Canada has one of the highest GDPs in the world: about US$2.1 trillion, placing it in the top 10 among countries' GDPs. All that money flowing through the country inevitably results in Canadian businessmen and investors placing some portion of their savings and investments in overseas markets.

On a personal level, Canadians have a high awareness of the world because we like to travel whenever we can, especially during the winter months. We love traveling to the United States, Europe, the Caribbean, Asia, Oceania, Central and South America, and just about everywhere else. Many Canadians move overseas after retirement, particularly to temperate climates. For them the travel is often reversed: they change their residency to another country and periodically return to Canada as a visitor instead of a returning resident.

This high international awareness contributes to many Canadians actively investing funds in business and investments outside of Canada. An important factor for such Canadians is the income taxation of their activities in foreign countries. Canadian income tax law has special and specific provisions for income derived from foreign sources. The application of the special tax law provisions depends on whether the individual is a resident or a non-resident of Canada. This book lays out the most important income tax rules for globally-minded Canadian residents and non-residents.

Chapter I: Introduction and Chapter II: Two Key Income Tax Fundamentals of this book lay the foundation for the discussions in Chapters III and IV (Income Taxation Of Residents and Income Taxation of Non-residents, respectively). Chapters III and IV represent the core materials in this book. Depending on your residency status and international plans, one of these two chapters will likely be of more interest to you than the other.

The last part of the book, Chapter V: Income Taxation In The Departure Year, is about the transition year when a resident becomes a non-resident, referred to as the departure year. Special tax rules apply to the departure year. This part will be of interest to you if you are in the midst of such a transition, or are planning to move to a foreign country and want to inform yourself beforehand of Canadian tax rules that apply to the departure year.

Before continuing on to Chapter II, in the next section, A. Phases Of Internationalization, we look at a framework for discussing the taxation of residents versus the taxation of non-residents. The subsequent section, B. Provincial Taxes, makes a brief comment on provincial income taxes (versus income taxes imposed by the federal government).

Let us now discuss our framework, the phases of internationalization.

A. Phases Of Internationalization

As a framework for discussion, we can think of a globally-minded Canadian being in one of four phases of taxation at any one point in time:

1. Taxation as a Canadian resident, with all income and assets within Canada.

2. Taxation as a Canadian resident, with a combination of Canadian and foreign income and/or foreign assets.
3. Taxation as a Canadian non-resident, with a combination of Canadian and foreign income and/or foreign assets.
4. Taxation as a Canadian non-resident, with all income and assets outside of Canada.

During their lifetime, an individual may move from one phase to the next and at one point or another be in all four phases. Other individuals enter one or more, but not all, of the four phases. Each person's situation and objectives are unique. The rules related to tax residency and what defines a resident versus a non-resident are set forth in Chapter II.

The first phase applies to most Canadian residents: all their income and assets are within Canada. None of the taxation rules related to foreign income and foreign assets would apply in this phase.

In the second phase of internationalization, the individual has acquired foreign assets, and may also be receiving foreign income on those assets. If foreign income is being received, then the individual has a combination of Canadian-source income and foreign-source income, and would be subject to the special tax rules that apply to foreign income. These special rules include, for example: the foreign tax credit on income taxes paid to a foreign country, taxation rules related to income/receipts from foreign estates and foreign trusts, and the Foreign Accrual Property Income (FAPI) rules. All of these, and more, are discussed in Chapter III.

In addition to the special taxation rules that apply to foreign income, there also exist special information reporting rules on foreign holdings and transactions imposed by the Canada Revenue Agency (CRA). These special reporting rules are covered in Chapter III as well.

Phases 3 and 4 involve non-residents. A non-resident is subject to Canadian income taxation on Canadian-source income only (Phase 3). The non-resident without any Canadian-source income (Phase 4) would not be subject to Canadian income taxation.

For non-residents in Phase 3, the income tax payable on each individual item of Canadian-source income is based on one of two methods, depending on the type of income. One method is through tax withholding at the source, i.e., the Canadian payer of the income withholds tax before remitting a payment net of tax to the non-resident. The other method is through the filing of an income tax return, in which tax on the income reported in the tax return is calculated, and payment made to the CRA. The taxation of non-residents is the basis for Chapter IV.

The year in which a resident individual sufficiently severs ties with Canada such that they are no longer considered a tax resident, in other words, the year in which an individual transitions from Phase 1 or 2 to Phase 3 or 4, is referred to as the departure year. In a departure year an individual taxpayer is a part-year resident for the first part of the year, and a part-year non-resident for the latter part of the year. The departure year presents a set of unique taxation rules. These are the main topic of Chapter V.

B. Provincial Taxes

The principles, concepts and tax planning points described in this book focus on Canadian federal taxation. Discussions of provincial taxation are limited. Each of the ten provinces and three territories, have their own income tax act and set of income tax rules. Nonetheless, as a general rule, provincial tax laws mirror federal tax laws in terms of the calculation of taxable income.

In analysing a situation (e.g., a proposed transaction, a proposed investment, etc.) for a resident of Canada engaging in international activities, as a starting point one can assume similar treatment for provincial tax as for federal tax, and add an additional amount for provincial tax to the federal tax amount to arrive at total tax. The rule of thumb is to assume an additional 50% on top of the federal tax amount to arrive at the total federal plus provincial tax. This rule of thumb can be applied in the case of deemed residents (a specific category of resident status) as well, to take into account the 48% federal surtax on deemed residents discussed later in this book.

The rule of thumb is, of course, just a general rule. The specific provincial/territorial tax rules and tax rates that may apply in any situation should always be investigated and considered before an analysis is completed.

CHAPTER II

Two Key Income Tax Fundamentals

To begin our discussion of income tax planning for the Canadian global citizen, we'll review two key fundamentals: tax residency and tax treaties. These two fundamentals serve as the foundation for income taxation. That is to say, determining your residency status, and whether any tax treaties are applicable to your situation, will serve as the basis for how you will be taxed by the Government of Canada and, as applicable, a foreign country. Accordingly, understanding the fundamentals of tax residency and tax treaties will enhance your ability to undertake international tax planning.

A. Tax Residency

1. Residency In General

Residency status determines how you are taxed under the Income Tax Act (ITA). A resident is subject to Canadian income tax on worldwide income from all sources. On the other hand, a non-resident is only subject to Canadian income taxation on Canadian-source income, i.e., income from sources within Canada.

Meeting the definition of residency for tax purposes is different from meeting the definition for other purposes. You could, for example, be considered a resident for tax purposes but a non-resident for purposes of health care coverage. Hence, it is important to understand the tax residency definition rules, as they play a large part in determining how you will be taxed by Canada.

A common misconception is that tax residency is strictly a six-month rule: spend more than six months in Canada and you are a resident, spend less than six months and you are a non-resident. This is oversimplified and does not capture the complexity of Canadian tax residency rules. There are several sets of tests for determining residency, only one of which may be characterized as a six-month rule.

The sets of residency tests are applied in a hierarchical manner. This means that the following procedure is applied: Apply the first set of tests, and if you meet the definition of resident thereunder then you are designated a resident. If not, you go to the next set of tests. With the next set of tests, you do the same, i.e., repeat the cycle of checking to see if you meet the test and stopping there if you do or moving on to the next set of tests if you don't. And so forth.

Before discussing the various residency tests, there is one other point to bring to your awareness. It is possible to be a resident for part of the taxation (calendar) year and a non-resident for the other part. This would be typical for a Canadian who expatriates, i.e., moves from Canada to another country. The terms often used in this circumstance are part-year resident and part-year non-resident.

Assume, for example, a Canadian resident who moves to Barbados on March 31. Subsequent to the move the individual no longer meets any of the Canadian tax residency rules, and is, accordingly, designated a non-resident. In this situation, the individual is a Canadian resident for the first three months of the year (January through March) and a non-resident for the other nine months of the year (April through December). The individual would therefore pay Canadian taxes (a) on worldwide income for the January-March period, and (b) on Canadian-source income for the April-December period. The individual may or may not have to also pay taxes to Barbados, depending on that country's tax laws.

Continuing with the example, subsequent to the year of the move the Canadian would be taxed by Canada as a non-resident, and would therefore pay Canadian tax on Canadian-source income only.

Further continuing with the example, assume that several years later the individual moves back to Canada, on Aug. 1. In that year, for Canadian tax purposes, the individual would be a non-resident for the first seven months of the year (January through July) and a resident for the other five months (August through December).

There exists a special set of tax rules for the year of expatriation (the year that a Canadian's residency status changes from resident to non-resident). These special rules, referred to as the departure tax, apply to the part-year resident portion of the year in which a Canadian expatriates to another country. The departure tax is discussed in Chapter V: Income Taxation In The Departure Year.

2. Residency Tests

There are two main categories of tests: factual residence and deemed residence. The factual residence tests are applied first. Failing all of those tests, the deemed residence tests are then applied. Failing all of the factual residence and deemed residence tests results in the individual being designated a non-resident.

a. Factual Residence

The factual residence tests are broken down between two types: **significant residential ties** and **secondary residential ties**. Let's first discuss the significant residential ties.

Significant Residential Ties

If you were to move to another country but maintain one or more significant residential ties to Canada after your move, then you would continue to be considered a resident for tax purposes, unless an applicable tax treaty holds otherwise. Tax treaties are discussed later in this chapter.

The significant residential ties are:

- A dwelling place (or places) in Canada;
- A spouse or common-law partner in Canada;
- Dependants in Canada.

A dwelling place is essentially a house, apartment or other living space that you have available to stay in any time you visit Canada. It could be a dwelling place that you own or it could be one that you rent.

A spouse or common-law partner is fairly self-explanatory. Of note here is that federal tax law defines a common-law partner as a person who is not your spouse with whom you have a conjugal relationship, and in which at least one of the following situations applies:

- You have been living together for at least 12 continuous months. The definition of 12 continuous months includes any period in which you were separated for less than 90 days because of a breakdown in the relationship.
- Your partner is the parent of your child by birth or adoption.
- Your partner has custody and control of your child (or had custody and control immediately before the child turned 19 years of age) and your child is wholly dependent on them for support.

A dependant is someone, usually a child, who is wholly dependent for support on you, or on you and other person(s).

Meeting any one of the above three significant residential ties makes one a factual resident of Canada.

Secondary Residential Ties

If you did not maintain any significant residential ties to Canada after your move to a foreign country, the next set of residential tests to be examined are the secondary residential ties. Unlike with the significant residential ties, which result in residency status if any one of the ties are maintained, the secondary residential ties are considered collectively rather than singularly.

The following are specifically listed as secondary residential ties by the CRA:

- Personal property in Canada (such as furniture, clothing, automobiles, and recreational vehicles);
- Social ties with Canada (such as memberships in Canadian recreational or religious organizations);
- Economic ties with Canada (such as employment with a Canadian employer and active involvement

in a Canadian business, and Canadian bank accounts, retirement savings plans, credit cards, and securities accounts);
- Landed immigrant status or appropriate work permits in Canada;
- Hospitalization and medical insurance coverage from a province or territory of Canada;
- A driver's license from a province or territory of Canada;
- A vehicle registered in a province or territory of Canada;
- A seasonal dwelling place in Canada or a leased dwelling place;
- A Canadian passport;
- Memberships in Canadian unions or professional organizations.

There are other secondary residential ties that may be taken into account by the CRA in determining an individual's residency status. For example: the retention of a Canadian mailing address, post office box, or safety deposit box; personal stationery (including business cards) showing a Canadian address; telephone listings in Canada; and Canadian newspaper and magazine subscriptions.

There are no specific rules as to how many of the secondary residential ties must be met for someone to be considered a resident. Judgment is involved. The CRA states that "it would be unusual for a single secondary residential tie with Canada to be sufficient on its own to lead to a determination that an individual is factually resident in Canada while abroad" but does not go any further in giving guidance on this point.

Accordingly, it is left up to one's judgment to determine whether the secondary residential ties, collectively, are enough to make one a factual resident. For those who want some certainty in this regard, there is a form that may be filed with the CRA to get their opinion on whether you are a resident or a non-resident. It is Form NR73 (Determination of Residency Status—leaving Canada), which you complete and file with the CRA. They will review the information you submit and respond to you with their determination of your residency status.

Before moving to the discussion of the set of tests for deemed residence, a final point is worth mentioning. The determination of factual residence is ultimately, like many things under Canadian law in general, based on the facts and circumstances. While the sets of tests described above serve as guidance provided by the CRA, given a particular individual's special set of circumstances it is possible that an argument could be made for a residency status different from what the tests would suggest. An individual who felt strongly about their situation and the correct residency status for themselves could make that argument to the CRA and, ultimately if necessary, before a court. Nevertheless, the factual residence tests set forth above serve as reliable guidance for individual taxpayers.

b. Deemed Residence

As explained earlier, the deemed residence tests are applied if none of the factual residence tests are met. The following lists the deemed residence tests. Meeting any one of these makes one a tax resident.

- Sojourners;
- Individuals who were members of the Canadian Forces at any time in the year;
- Individuals who were officers or servants of Canada or a province, at any time in the year, who received representation allowances or who were factually or deemed resident in Canada immediately prior to appointment or employment by Canada or the province;
- Individuals who performed services, at any time in the year, outside Canada under an international development assistance program of the Canadian International Development Agency described in section 3400 of the Regulations, provided they were either factually or deemed resident in Canada at any time in the three month period prior to the day the services commenced;
- Individuals who were, at any time in the year, members of the overseas Canadian Forces school staff who have filed their returns for the year on the basis that they were resident in Canada throughout the period during which they were such members;
- Individuals who were at any time in the year a child of, and dependent for support on, an individual described in (a) to (d), and whose

income for the year did not exceed the basic personal amount for the year;

- Individuals who at any time in the year were, under an agreement or a convention (including a tax treaty) between Canada and another country, entitled to an exemption from an income tax that would otherwise be payable in that other country in respect of income from any source, and:
  - The exemption under the agreement or convention applies to all or substantially all of their income from all sources (that is, they are subject to tax in the other country on less than 10% of their income as a result of the exemption); and
  - The individuals were entitled to the exemption because they were related to, or a member of the family of, an individual (other than a trust) who was resident (including deemed resident) in Canada at the particular time.

Other than the first entry, sojourners, the various tests relate in some way or other to employment or the execution of duties for an arm of the federal government, a provincial government, or a governmental agency. The descriptions of these are self-explanatory and will not be discussed further here.

The first entry above, the sojourner category, is informally known as the six-month rule or 183-day rule. To sojourn means to be temporarily present. Under Canadian tax law a sojourner is an individual who is not a factual resident but who sojourns in Canada for a total of 183 days or more in any calendar year. The CRA considers any part of a day to be a full day for the purpose of determining the number of days in a calendar year that an individual has sojourned.

An individual who spends time in Canada is not automatically considered to be sojourning for every day they are present in Canada. For example, an individual who commutes to Canada for employment and returns each night to their normal place of residence outside of Canada is not considered to be a sojourner, and their days spent in Canada as a commuter are not counted toward the sojourner rule. The key is whether the individual is temporarily staying in Canada for vacation or similar purposes. In other words, sojourning.

The tax ramifications of being a deemed resident are different from those of a factual resident in a couple of key respects. One is that a deemed resident is deemed to be a tax resident for the whole taxation year (January through December), and not just for the portion of the year they are physically in Canada. Hence, with deemed residency there is no part-year residency plus part-year non-residency for a taxation year as with factual residency.

The other key distinction to be made between the tax impact of deemed residency versus factual residency relates to provincial tax. A factual resident would be a resident of a particular province, and accordingly pay provincial tax based on that province's tax rates. A deemed resident, in contrast, is not a resident of any province. With the objective of ensuring that a deemed resident does not pay less tax than the tax paid by a factual resident with the same amount of taxable income as the deemed resident, Canadian tax law provides for a federal surtax on deemed residents. This federal surtax is 48% of the amount of the federal tax.

Here is an example of how the surtax works. Assume that an individual is a deemed resident with taxable worldwide income of CA$216,000, and a federal tax on that taxable income of CA$50,000. The federal surtax would be CA$50,000 x 48% = CA$24,000. Accordingly, the total Canadian tax bill for this deemed resident would be CA$50,000 + CA$24,000 = CA$74,000.

3. Provincial Residency

Generally, an individual who is considered a factual resident is subject to provincial tax on their worldwide income based on the province in which they resided on Dec. 31 of the particular taxation year.

It is unusual, although possible, for an individual to be considered a resident in more than one province on Dec. 31 of a particular year. In such a case, for purposes of the provincial tax, the individual will be considered to be resident only in the province in which they had the greatest degree of significant residential ties.

B. Tax Treaties

Countries of the world have bilateral tax treaties with each other. As of this writing Canada has tax treaties in force with about 95 countries. With another dozen or so countries, Canada has tax treaties that are either signed but not yet in force or under negotiation/re-negotiation.

Tax treaties are extremely important because, when applicable, their provisions override the income tax provisions of general Canadian tax law. A tax treaty will usually cover, at a minimum: residency, types of income that are taxable by each country, and withholding tax rates on certain types of income when income is paid out of one country to a recipient in the other country.

Among the important items covered by a tax treaty is the withholding tax rate on payments made from one country to a recipient who resides in the other country. For example, in the absence of a tax treaty, Canadian tax law provides that a dividend payment made by a Canadian corporation to a non-resident is subject to a withholding tax rate of 25%. A treaty will typically provide for a withholding tax rate less than 25%, e.g., 15% or some other rate less than 25%.

Here are a few examples of how a treaty could override the general tax provisions of Canada:

An individual expatriates to New Zealand. Although the individual lives in New Zealand full-time, they continue to meet one or more Canadian residency tests and, in the absence of a treaty, would be considered a tax resident of Canada. However, under the Canada-New Zealand tax treaty, and its provisions for determining residency, the individual will be considered a resident of New Zealand and a non-resident of Canada.

An independent professional who provides services to a Canadian company expatriates to Portugal, where they continue to provide professional services to the Canadian company after the move. In the absence of a treaty, the individual's payments from the Canadian company would be Canadian-source income taxable by Canada. However, under the Canada-Portugal tax treaty, the professional fees would be taxable by Portugal not Canada.

A retiree expatriates to Thailand. A portion of the individual's regular income is dividends from a Canadian corporation. In the absence of a treaty, under Canada's general laws, after the move to Thailand the individual would pay a 25% withholding tax to Canada. However, under the Canada-Thailand tax treaty, the withholding tax rate is 15% and, accordingly, the individual would pay a 15% tax, rather than a 25% tax, to Canada on dividend income.

As illustrated in the above examples, a tax treaty can have an important impact on how a Canadian is taxed after expatriation to another country. It is vital to know if a tax treaty exists between Canada and the country to which you are contemplating a move, or have moved and, if such a treaty exists, understand how its provisions affect your tax obligations to both Canada and the country of your residence.

C. Chapter II Summary

Tax residency and tax treaties are two key income tax fundamentals that form the basis on which an individual will be taxed by Canada. These two fundamentals are discussed in this chapter.

Under general Canadian tax law, a tax resident is taxed on their worldwide income while a non-resident is taxed on their Canadian-source income only. The definition of residency is complex, with a hierarchy of rules that one applies in sequence. As one moves down the hierarchy of rules, at any point where the definition of resident is met, one can stop as they have met the definition of tax resident. If none of the rules, taken in sequence, are met, then one is determined to be a non-resident.

Tax treaties are bilateral agreements between two countries. Canada currently has in-force tax treaties with about 95 countries, and treaties that have been signed but are not yet in force or are under negotiation/re-negotiation, with another dozen or so countries. Wherever there is a contradiction between the provisions of a tax treaty and the general tax law provisions of either Canada or the other country, the tax treaty provisions prevail. It is important for both Canadian residents and Canadian non-residents to know if there is a tax treaty that may apply to them, and be aware of how that treaty impacts their situation.

Having established these two income tax fundamentals for the globally-minded Canadian, we proceed to examine income taxation issues for residents and non-residents. We first review income tax issues for residents (Chapter III), then for non-residents (Chapter IV), followed by issues related to the year that a Canadian's status changes from resident to non-resident, otherwise known as the departure year (Chapter V).

CHAPTER III

Income Taxation Of Residents

A. Taxation Based On Worldwide Income

In Chapter II, Section A. Tax Residency, the concept of worldwide income was briefly introduced. As stated then, a tax resident is subject to Canadian income tax on worldwide income from all sources. In contrast, a non-resident is subject to Canadian income tax on Canadian-source income only, i.e., income from sources within Canada.

This chapter focuses on Canadian taxation issues for the resident who generates foreign source income through foreign investments and other foreign activities. Chapter IV will focus on the Canadian taxation of non-residents' Canadian-source income. In Chapter V the special rules that apply in the calendar year that a Canadian resident becomes a non-resident (the departure year) will be explored.

The underlying concept of taxation based on worldwide income from all sources means that a Canadian resident must report both Canadian-source income and foreign source income in their annual income tax return. It is important to note, however, that some foreign source income gets a different tax treatment than the equivalent Canadian-source income. As an example, there is a difference in the tax treatment of foreign dividend income as compared to the tax treatment of dividend income from a Canadian corporation. This difference and the differences in tax treatment in other types of income are investigated in the following sections in this chapter.

It is worth noting that the income tax return form (technically the Income Tax and Benefit Return) that a resident must file with the CRA differs depending on residency status (resident or non-resident). Furthermore, for residents, the specific form that must be filed differs depending on the province or territory in which the individual resides. This is due to the fact that, with the exception of Quebec, the federal government collects provincial taxes on behalf of the provinces and territories, and distributes the funds collected accordingly, through the CRA.

B. Foreign Tax Credit

A normal Canadian income tax return is composed of various parts spanning multiple pages. These various parts bring together income, deductions, calculation of tax, calculation of tax credits, and tax payments, to arrive at the balance of tax owing (or refund due). The parts for tax credits have lines for various credits such as the basic personal amount credit, dividend tax credit, and the political contribution credit. One of the credits is the foreign tax credit. In common among all tax credits is that they reduce tax payable on a one-to-one basis. A CA$50 charitable donation credit, for example, reduces tax payable by CA$50.

The foreign tax credit is a credit for the payment of foreign taxes, i.e., taxes paid to a foreign government or agency, on investment or other income generated in that country. In practice the foreign tax credit actually behaves as if it were several individual credits. For example, separate foreign tax credit calculations must be made for each country, and within each country for business income and non-business income.

For example, if you have income-generating investments in Chile and Portugal, and pay taxes to Chile and Portugal on your respective investments in those countries, you must calculate separate foreign tax credits for the non-business income (the income from the investments) in each of those countries. The reason for this is that the foreign tax credit calculation involves a lesser-of-two calculation for each foreign tax paid. An individual is entitled to a credit for the lesser of (a) the actual foreign taxes paid on foreign income and (b) the amount of Canadian tax attributable to that same income.

Depending on one's situation, for example, the amount of the foreign tax credit allowable on one foreign source income may be the actual foreign tax paid (item (a) above), while the amount of the foreign tax credit allowable on another foreign source income may be the amount of Canadian tax attributable to that same income (item (b) above). Hence, a separate foreign tax credit calculation must be made on each foreign source income.

The foreign tax credit calculation can range from being straightforward and easy to being quite complex. Of special note is that the foreign tax credit rules for business income differ from those for non-business income in one important way: carrybacks and carryforwards of excess foreign tax credits.

The lesser-of-two calculation previously described could result in an excess foreign tax credit, meaning that the amount of foreign taxes actually paid was greater than the foreign tax credit allowed on the tax return. In such a situation, the treatment of the excess foreign tax credit is dependent on whether it relates to business income or non-business income.

Excess foreign tax credits for foreign taxes on business income can be carried forward for ten years and carried back for three years, to reduce the income tax payable in those years.

For non-business income, the rules are different. Unused foreign tax credits on non-business income cannot be carried forward or carried back; instead, they may be taken as a deduction against income. This provides some relief for the excess foreign taxes paid on non-business income that cannot be used as a tax credit.

As mentioned, a tax credit reduces tax on a one-to-one basis: a CA$2,000 tax credit results in tax savings of CA$2,000. A tax deduction, however, only reduces tax in proportion to one's marginal tax bracket. For example, for someone in a 33% federal tax bracket, a tax deduction of CA$2,000 will result in tax savings of CA$2,000 x 33% = CA$660. Hence, a credit is almost always better than a deduction. Nevertheless, the foreign tax credit rules for excess foreign tax credits on non-business income provide some additional relief, and some relief is better than none.

C. Foreign Dividend Income

Dividends received from a Canadian corporation are taxed in this manner: the amount of dividend received is grossed-up, the grossed-up dividend amount becomes part of taxable income, and a dividend tax credit is allowed on the dividend income. An example to illustrate how this works:

An individual owns shares of stock in two corporations, corporations A and B. Corporation A's stock is publicly-traded, and it pays eligible dividends. Corporation B is a privately held corporation that pays non-eligible dividends. During the year the individual receives CA$1,000 in dividends from each corporation.

To determine the tax attributable to this individual's dividend income, the dividend income must first be grossed-up, as follows:

- Eligible dividends (138% gross-up): CA$1,000 x 138% = CA$1,380 taxable dividends
- Non-eligible dividends (115% gross-up): CA$1,000 x 115% = CA$1,150 taxable dividends

Taxable dividends are thus: CA$1,380 + CA$1,150 = CA$2,530. Ignoring provincial taxes, and assuming that the individual is in a 33% federal tax bracket, the amount of federal tax on these dividends would be CA$2,530 x 33% = CA$835.

We are not done yet, though. We must next calculate the dividend tax credit for each dividend. These calculations are:

- Eligible dividends (15%): CA$1,380 x 15% = CA$207
- Non-eligible dividends (9%) = CA$1,150 x 9% = CA$104

The combined dividend tax credit is therefore CA$207 + CA$104 = CA$311. The net federal tax payable on dividend income is thus CA$835 minus CA$311 = CA$524.

Dividends received from a foreign corporation have a different tax treatment. First, there is no gross-up of the dividend, i.e., whatever the amount of the dividend that is what is includable in income. Second, no dividend tax credit is available for foreign dividend income. Third, a foreign tax credit is available for taxes paid to a foreign country on the foreign dividend income.

Here is an example:

An individual is a shareholder in a foreign corporation whose stock is traded on that country's main stock exchange. During the year the individual received CA$1,000 in dividends from the corporation, and paid a foreign tax of 25%, or CA$250, on that dividend income.

The individual will include CA$1,000 of foreign dividend income in their tax return. Assuming the same 33% federal tax bracket as in the preceding example, the individual's federal tax on this income is CA$1,000 x 33% = CA$330.

A foreign tax credit is available on the foreign taxes that were paid on this dividend income. Per my discussion in Section B. Foreign Tax Credit above, the rule for tax credits is that the individual is entitled to a credit for the lesser of the actual foreign taxes paid and the amount of Canadian tax on the same income. In our example, the actual foreign taxes (CA$250) were less than the Canadian tax on the income (CA$330), hence, the foreign tax credit would be CA$250. Accordingly, the net Canadian tax payable on the foreign dividend income is CA$330 minus CA$250 = CA$80.

Note that, in this example, the total tax paid to all governments is CA$330, composed of CA$250 (foreign) and CA$80 (Canadian). This is the same amount that was calculated as the amount of Canadian tax on the income, before the foreign tax credit.

If the amount of the foreign tax had been higher than the amount of Canadian tax on the same income, the outcome on the Canadian tax return would be different. Assume the same facts as before except that the foreign tax rate was 40%, and the amount of foreign tax paid was CA$400. In this case, the amount of foreign tax credit on the Canadian tax return would be the lesser of (a) the actual foreign taxes paid (CA$400) and (b) the amount of Canadian tax on the same income (CA$330). The foreign tax amount would therefore be CA$330. The resulting net tax on the foreign dividend income would therefore be CA$330 minus CA$330, or zero.

In the situation just described, there is an excess foreign tax credit, i.e., the amount of actual foreign taxes paid was greater than the allowable foreign tax credit on the tax return. As discussed above, the treatment of excess foreign tax credits depends on whether the associated income was business income or non-business income. In the present example, the income was non-business income, so the excess foreign tax credit amount would be available as a tax deduction. That excess, in our example, was CA$400 minus CA$330, or CA$70. This CA$70 could be used as a tax deduction in the individual's tax return to offset other sources of income.

As a general rule, the overall tax rate paid to all tax authorities on foreign dividend income usually ends up being the higher of one's foreign tax rate and one's Canadian marginal tax rate.

D. Foreign Trusts

There was a time when Canadian residents could use offshore trusts as a vehicle to defer, minimize or escape Canadian taxation on investment income. However, under current tax laws, the use of foreign trusts for Canadians is no longer the great tax reduction tactic it once was. While the use of foreign trusts continues to be a very valid tool for non-tax reasons, such as estate planning and international diversification, in terms of tax planning, foreign trusts provide few opportunities to minimize a Canadian resident's income taxes.

Several provisions within the Income Tax Act (ITA) make foreign trusts a challenging area of tax planning. The web of tax rules is complex and can result in a tax trap for the unwary. In this section we will review many of the important tax rules. It is important to state, though, that the coverage of the topic in this section is "scratching the surface" of Canadian taxation of foreign trusts. The coverage of foreign trusts herein has been simplified to highlight the key points. As always, seeking professional tax advice when undertaking a planning tool such as foreign trusts is highly recommended.

Before delving into the key points of which you should be aware regarding the tax rules for foreign trusts, we will review (1) general trust taxation rules, and (2) trust residency. These topics will set the stage for the main discussion on foreign trusts.

1. General Trust Taxation Rules

To understand the general taxation rules on trusts, it is important to understand the role of each party that forms the trust relationship. A trust is a legal relationship in which one party (the settlor) gives a second party (the trustee) the right to hold title to property or assets for the benefit of a third party (the beneficiary). The settlor sets up the trust by creating a trust document and contributing assets to the trust. Title to the assets is taken by the trustee. The trustee manages the assets for the benefit of the beneficiaries as instructed by the trust document. The beneficiaries receive trust income and/or principal during the life of the trust as per the trust document and/or at the trustee's discretion if such discretion is provided by the trust document.

Under the Income Tax Act (ITA), trusts are considered one of three types of entities that are taxable (individuals and corporations are the other two). The tax rules that apply to trusts in determining income, deductions, taxable income, and amount of tax payable, are similar to those that apply to individuals. However, there are some key differences. One is that trusts do not benefit from graduated tax rates as individuals do. Instead, trusts are taxed at the highest individual tax rate (currently the top federal tax rate is 33%). Another key difference is that trusts are entitled to a deduction for income that is distributed to beneficiaries (or is deemed to have been distributed under the trust document's provisions). The income then gets taxed in the hands of the beneficiary.

As a simple example, assume a trust that has one beneficiary. During the year the trust had taxable income of CA$100,000. If the trust retains all of that income, i.e., does not make any distributions to its beneficiary, then it will have federal tax payable of CA$100,000 x 33% = CA$33,000 for the year. Alternatively, if the trust distributes all of this income to the beneficiary, then it gets a CA$100,000 deduction for the distribution, resulting in taxable income of CA$100,000 minus CA$100,000 = CA$0, and a resulting tax payable of CA$0. The beneficiary includes the $100,000 distribution from the trust as taxable income in their tax return for the year.

Income distributed by a trust to a beneficiary retains its character. Continuing with the above example, assume that the CA$100,000 of taxable income was composed of CA$60,000 in dividend income and CA$40,000 in interest income. The trust beneficiary would receive a T3 slip from the trustee indicating this information, and the beneficiary would incorporate CA$60,000 of dividend income and CA$40,000 of interest income in their tax return.

Another point about general trust taxation worth mentioning is the 21-year rule. This rule provides that every 21 years a trust is deemed to have sold its assets at fair market value, and immediately reacquired the assets at the same value. The purpose of this rule is to prevent trusts from holding appreciating assets, such as stocks or real estate, indefinitely without paying tax on the unrealized capital gains. Application of the 21-year rule results in deemed dispositions of assets, and the resulting taxation of capital gains on appreciated assets, even though the assets were not actually sold.

The simple review of trust taxation above assumes that both the trust and the beneficiary are resident in Canada. However, different combinations of residency are possible. The four possible combinations are:

1. Resident trust/resident beneficiary;
2. Non-resident trust/resident beneficiary;
3. Resident trust/non-resident beneficiary;
4. Non-resident trust/non-resident beneficiary.

The general trust taxation rules just discussed apply to the first combination. The rest of the discussion in this chapter will focus on the second combination: a non-resident trust with a resident trust beneficiary. In the next chapter the third combination will be examined. The fourth combination will not be discussed as there is nothing much to say about it in terms of Canadian taxation, i.e., neither the non-resident trust nor the non-resident beneficiary would be subject to taxation by Canada.

In general, when we think of a foreign trust, we are contemplating a non-resident trust. However, as will be seen in the next section, it is quite possible for a foreign trust to be considered resident in Canada and taxed accordingly. It is therefore of utmost importance to be aware of the trust residency rules, so as to avoid being caught by surprise by the traps that lay within the tax law.

2. Trust Residency

Chapter 2 reviewed the tax residency rules for individuals. Trusts have their own set of residency rules that determine whether a trust is resident or non-resident for Canadian tax purposes. The issue of residency is important as it impacts how the trust's income will be taxed in Canada. A trust that is resident in Canada is subject to tax on its worldwide income, while a non-resident trust is subject to tax on Canadian-source income only.

The main principle in determining whether a trust is a resident of Canada is the location of the trust's central management and control. Normally this means where the trustees reside: if the trustee(s) resides in Canada, the trust is resident; if the trustee(s) resides outside of Canada, the trust is non-resident.

Notwithstanding, there are other sets of rules that could result in a trust being deemed resident even when all trustees reside outside of Canada. One of these relates to contributions. When a trust is created, the original contributor to the trust is usually the settlor. However, it is possible for someone other than the settlor to contribute to a trust. One set of trust residency rules holds that a trust is deemed to be resident if an individual contributor is a resident in Canada at the end of a taxation year. This rule applies even if the contributions by the individual were made when that individual was a non-resident.

Another set of trust residency rules results in the trust being deemed resident when one or more beneficiaries are resident in Canada and contributions made to the trust were by a person who was (a) a Canadian resident at the time, or (b) had been a resident in the past five years, or (c) becomes a resident during the five years following the contribution.

Depending on which set of trust residency rules applies, trust income will be subject to tax either in the hands of the trust or in the hands of the beneficiary to whom that income is allocated. The details of the rules are technical and involved, and beyond the scope of this book's coverage. There are various factors a combination of which determine residency and how a trust and its beneficiaries are taxed. Thus, the importance of getting competent professional advice for planning related to the creation of a trust document, the planning and execution of contributions to the trust, the planning and execution of distributions to beneficiaries, and other transactions, such as loans, between the trust and beneficiaries.

In summary, a foreign trust can be deemed to have Canadian residency in spite of it being created outside of Canada, and in spite of its trustee(s) having residency outside of Canada. Canadian trust residency rules are quite complex when there is some element of internationalization involved. Proper tax planning at the outset, and careful execution after the trust is in place, is critical to ensure objectives are achieved.

3. Taxation Of A Resident Beneficiary Of A Non-Resident Trust

The broad review of trust residency rules above should make it clear that it is not an easy matter for a trust to be classified as non-resident. If the settlor or the trustee(s) or any non-settlor contributor has residential ties to Canada, there is a good likelihood that the trust will be designated as resident, and accordingly be subject to Canadian taxation on worldwide trust income.

There are, nonetheless, situations in which a trust can qualify as non-resident even with resident beneficiary(ies). An illustration will help make this point. Assume that a non-resident individual creates a trust in their country of residence; the individual is thereby the settlor of the trust. The trust is administered by a non-resident trustee, for the benefit of the settlor's child who is also non-resident at the time the trust is created. Over the years all contributions to the trust are made by the non-resident settlor of the trust. All income earned by the trust is non-Canadian-source income. When the child reaches working age, they accept a job in Canada and become a Canadian resident.

In the just described situation, the trust is non-resident and the beneficiary, after moving to Canada, is resident. The trust would not be subject to Canadian taxation as it does not generate any Canadian-source income. Any income distributed by the trust to the beneficiary would be subject to Canadian tax in the hands of the individual beneficiary. Additionally, the resident beneficiary must fulfill an information filing requirement: the filing of Form T1142 (Information Return in Respect of Distributions From and Indebtedness to a Non-Resident Trust) with the CRA.

Continuing with the example, a potential tax planning technique may be available. The trustee could delay distributions to the beneficiary until sometime after the year that the associated income was earned. Instead of distributing the income to the beneficiary in the year earned, the trustee could retain the income and add it to trust capital. The trustee could then make a distribution to the beneficiary from the trust's capital in a subsequent year. Since the beneficiary receives capital rather than income, it would not be taxable on the receipt of distributions. The beneficiary must still report the trust distributions received in the aforementioned Form T1142, but would not be taxable on any portion of the distributions, because they were capital distributions rather than income distributions. This strategy must be carefully executed with proper planning and documentation, such as having the trustee make a resolution that the distribution is from trust capital and ensuring that the trust's financial statements reflect this as well. With proper planning and execution, it could be a beneficial tax planning strategy.

It is worthwhile to note that the non-resident trust may have to pay taxes to the trustee's and/or settlor's country of residence, depending on the tax laws of those countries. Thus, it is important to understand the tax laws of all countries involved when considering tax planning strategies and ensure tax compliance with all countries' laws and regulations.

E. Foreign Estates

Upon the demise of an individual, their property and debt becomes part of their estate. The executor of the estate, someone who is named in the deceased's last will and testament (the will) or, if the deceased died intestate (without a will), someone named by the probate court, is charged with settling all of the estate's debt and subsequently distributing the assets that remain according to the terms of the deceased's will. When all assets have been distributed, the estate is closed. The period of time between the individual's death and final estate closure can be relatively short or it can be a considerable amount of time, sometimes years, depending on the complexity of the estate and how quickly the executor acts to administer the estate.

A will is a flexible document that can be drafted in just about any way that the individual would like it to be, based on their estate planning goals and objectives. Among the estate planning tools available to an individual are trusts created at their death, as per the terms of the will. Such trusts are referred to as testamentary trusts, in contrast to inter vivos trusts which are created by an individual during their lifetime.

In this section, as with the preceding one on foreign trusts, we first discuss the general Canadian tax rules related to estates, then proceed to discuss the taxation of a resident beneficiary of a non-resident estate.

1. General Estate Taxation Rules

Among the debts that an estate's executor may have to pay are Canadian taxes imposed on the individual's income for the year of death. The calculation of these income taxes, and the forms used for these calculations, can get complex. The main concept for our purposes, though, is that a deceased individual is deemed to have disposed of all of their assets at fair market value on the date of death.

The resulting capital gains and capital losses from the deemed sale of the deceased's property are included in the individual's final income tax return. The assets have not actually been sold, though. Those assets carry over into the estate with an adjusted cost base equal to the deemed proceeds of disposition, i.e., their fair market values. Estate beneficiaries who later receive asset distributions receive those assets with this adjusted cost base.

There are exceptions to the above rules, most notably when estate assets are transferred into a spousal trust, or are otherwise inherited by the surviving spouse or common-law partner. Depending on the circumstances and the types of assets, in such cases the assets passed on to the surviving spouse or partner are not deemed to have been disposed of at fair market value, and the deceased's cost base for the assets carry over to the surviving spouse or partner who inherits the assets.

Testamentary trusts created by the terms of a will are treated like other trusts for tax purposes. Refer to Section D. Foreign Trusts, Subsection 1. General Trust Taxation Rules above for a summary of the tax rules related to trusts.

An estate, during the period of its administration prior to all debts being settled and all assets being distributed to beneficiaries, is treated under Canadian tax law as if it were a trust and is taxed as such, with some important differences. The main one for our discussion is that the estate may benefit from graduated rates on the taxation of its income, like individuals do, rather than paying income tax at the top individual rate like most trusts do. This favourable tax treatment is allowed to the estate for the first 36 months after the deceased's date of death; subsequently the estate must pay tax on its income at the top tax rate.

It was previously mentioned, in Section D. Foreign Trusts, Subsection 1. General Trust Taxation Rules, that a trust pays tax on its income unless that income is distributed to beneficiaries during the taxation year, in which case the beneficiaries report the income and pay tax on it in their own income tax return. With estates, depending on the terms of the will, income may be taxed within the estate or in the hands of the beneficiaries. For example, the deceased's will may require the executor to pay the income tax on income earned by the estate, and distribute the after-tax income to the beneficiaries. Alternatively, in the absence of such a provision, the estate may distribute income to beneficiaries and the beneficiaries pay tax on that income, a result like that of a trust.

With this background on the general taxation rules for estates, let us now explore the issue of estate residency, and how a Canadian resident who is a beneficiary of a non-resident estate is taxed.

2. Estate Residency

The determination of whether an estate is resident or non-resident is much like that for a trust. An estate is a resident of Canada if its central management and control is in Canada. In the case of an estate, central management and control would lie in the hands of the executor. The country in which the deceased individual resided prior to death would likely be the same country in which the executor would reside, so in most cases the residency of the estate would be obvious.

A possible, even if unlikely, situation would be one in which the deceased was a Canadian resident and the named executor a non-resident. This would make the estate non-resident. Such a situation could have a variety of negative consequences. One, for example, would be that the estate could be subject to taxation by the country in which the non-resident executor resides. On the Canadian side, a potential negative effect is that the non-resident estate could lose the benefit of favourable taxation on some items, e.g., capital gains and Canadian corporation dividends that flow through to the estate's beneficiaries. There are other potential negative tax effects as well, a discussion of which is beyond our scope in this book.

There could be significant negative non-tax effects, as well. A bond may be required of the non-resident executor, which could be costly to obtain in terms of both money and time.

Considering the many and varied potential negative effects, and the few if any positive effects, of having a non-resident executor for the estate of a deceased Canadian resident, it is usually recommendable for a Canadian resident to name a resident executor in their will. It may also be a good idea to have the will name a substitute resident executor in the event that the first named executor becomes a non-resident prior to or during the estate's administration.

3. Taxation Of A Resident Beneficiary Of A Non-Resident Estate

The situation described in the last section, in which a deceased Canadian resident's estate is administered by a non-resident executor, would be uncommon and, as mentioned, usually not recommended. Not uncommon would be the estate of a deceased non-resident, administered by a non-resident executor, with one or more Canadian beneficiaries. In this situation, the estate itself would not be taxable in Canada, except to the extent that it has Canadian-source income.

The main issues that would arise with a resident beneficiary of a non-resident estate relate to the estate distributions to the beneficiary. Distributions of estate assets, i.e. estate capital, would not be taxable in the hands of the beneficiary. The question arises as to whether an estate's income distribution to a beneficiary would be taxable in the hands of the beneficiary. The answer to the question is not clear cut.

Technically, an estate is treated as a trust under Canadian tax law, and it would appear that, therefore, distributions of income earned by the estate during the year and distributed during the same year would be taxable in the hands of the beneficiary. However, there's an interesting aspect of information reporting that could conceivably be interpreted to mean that income distributions from a non-resident estate to a resident beneficiary are not taxable.

Earlier it was stated that a resident beneficiary of a non-resident trust who receives distributions during the year is required to file Form T1142 (Information Return in Respect of Distributions From and Indebtedness to a Non-Resident Trust) with the CRA. One would think that, since estates are treated like trusts under Canadian tax law, this filing requirement would apply to distributions from estates as well. However, the instructions to Form T1142 state that the beneficiary of an estate that arose on or as a consequence of death is not required to file the form.

The main purpose of Form T1142, and other forms like it that relate to the foreign activities of Canadian residents and which will be discussed later, is for Canadian residents who are recipients of payments from foreign sources to inform the CRA of those transactions, since they may be taxable. Forms such as T1142, in essence, are meant to serve as a substitute for the information reported to the CRA by resident payers of various types of income, e.g., the information in T3 slips that a resident trust is required to report to the CRA. Since non-resident payers, such as foreign trusts and foreign estates, have no obligation to the CRA to file information reports, the CRA has imposed information filing requirements on the resident recipients of the payments.

Going back to the instructions in Form T1142 that exclude resident beneficiaries of non-resident estates from having to file the form, one could logically infer that distributions from non-resident estates are not taxable in the hands of resident beneficiaries, even when such distributions may possibly contain income earned by the estate.

For practical purposes, it could be difficult or even close to impossible to establish which portion of a distribution from a foreign estate may represent income, and therefore be taxable in the hands of a Canadian resident beneficiary. Nonetheless, it is worth being aware of the issue. If one is a resident beneficiary of a foreign estate, consulting with a professional tax advisor on these matters is recommended.

F. FAPI – Paying Tax on Your Foreign Corporation's Income

At the beginning of Section D. Foreign Trusts in this chapter, it was noted that, under current tax laws, the use of foreign trusts for Canadian residents is no longer the effective tax reduction tactic it once was. The same can be said about the use of foreign corporations for investment purposes: it is no longer the tax reduction vehicle that it once was. One main reason is because of a set of tax rules referred to as Foreign Accrual Property Income (FAPI).

Under the FAPI rules, a Canadian resident who owns shares in a foreign corporation may be required to include their proportionate share of the foreign corporation's income in their own Canadian individual income tax return, even if the foreign corporation has not paid that income to them in the form of dividends. The FAPI rules are quite complex with a slew of definitions and exceptions. While the discussion that follows should give you a good idea of what FAPI is about, nonetheless you should seek professional help to determine how FAPI may affect you if you are contemplating the use of a foreign corporation for investment purposes.

FAPI rules apply when a Canadian resident owns more than 50% of a foreign corporation. Such a corporation is referred to as a "controlled foreign affiliate" of the Canadian resident shareholder. (The more general term "foreign affiliate" refers to when a Canadian resident owns 10% or more of a foreign corporation.) The type of income to which FAPI applies is, generally, passive income such as interest, capital gains, and rental income. FAPI does not apply to active business income. Assume that a Canadian resident was the sole shareholder of two foreign corporations. One of the foreign corporations is in the export business and generates income from this business only. The other foreign corporation invests in global securities and passive rental income properties, thereby generating investment income only. The FAPI rules would not apply to the income of the first corporation, but would apply to the income of the second corporation.

Under the FAPI rules, the resident shareholder determines their share of the corporation's pre-tax income for the year, deducts an amount for the corporation's taxes, and includes this net amount in the taxable income of their individual income tax return. This is irrespective of whether the resident shareholder received any actual dividends from the foreign corporation. If the foreign corporation did not pay dividends, it would be a situation in which the resident shareholder pays Canadian taxes on income for which they did not receive any cash payment. Such is FAPI.

The deduction for corporation taxes allowed in the FAPI computation is based on an arbitrary "relevant tax factor" established under the FAPI rules. For individual shareholders the relevant tax factor is 1.9. For corporate shareholders that are Canadian-controlled private corporations (CCPCs) the relevant tax factor is also 1.9, while for non-CCPC corporate shareholders the relevant tax factor is 4.0.

Let's look at an example of how the FAPI rules are applied.

An individual, resident of Canada, owns 60% of a foreign corporation. During the year, the corporation had pre-tax income of CA$20,000 (all of it passive investment income) and paid taxes of CA$5,000 on that income. The individual's share of the foreign corporation's income is CA$20,000 x 60% = CA$12,000. The individual's share of the foreign corporation's taxes paid is CA$5,000 x 60% = CA$3,000. The individual's deduction allowable for the foreign corporation's taxes is CA$3,000 x 1.9 = CA$5,700. Putting it all together, the amount of FAPI that the individual must include in income for the year is CA$12,000 minus CA$5,700 = CA$6,300. Ignoring provincial taxes, and assuming a federal marginal tax rate of 33%, the individual's federal tax payable on the FAPI would be CA$6,300 x 33% = CA$2,079.

The FAPI rules are designed to prevent the deferral of taxes on passive income earned by foreign corporations that are controlled or substantially owned by Canadian residents. If not for the FAPI rules, the foreign corporation could reinvest all of its income and not pay out dividends to its shareholders for many years. This would deprive the Canadian government of collecting taxes on the income earned by the foreign corporation, until such time that the corporation paid dividends to its Canadian resident shareholders. This is the tax authorities' premise for the FAPI rules.

The above is a simplified explanation of the FAPI rules. Several aspects of the FAPI rules are not mentioned in the above, such as:

- If the foreign corporation's total FAPI is CA$5,000 or less, then no amount of FAPI is taxable in the shareholder's income for the year.
- The definitions of "passive income" versus "active business income" have several nuances. Some types of passive income are considered active business income under the FAPI rules, and vice versa.
- The percentage to be used in calculating a shareholder's proportionate share of the foreign corporation's income is not always straightforward when more than one class of shares is issued by the foreign corporation.
- Negative FAPI cannot be used by the shareholder to offset Canadian income. However, negative FAPI can be carried back or carried forward to years with positive FAPI.

In addition to the income ramifications of FAPI, and the resulting effect on a Canadian resident's income tax return, there are information reports that may need to be filed with the CRA, depending on one's asset ownership structure, such as:

- Form T1134 (Information Return Relating To Controlled and Non-Controlled Foreign Affiliates); and
- Form T106 (Information Return of Non-Arm's Length Transactions with Non-Residents).

G. A Foreign Corporation Could Be Deemed Resident in Canada

The FAPI rules described in the last section are applicable to a foreign corporation that is defined as a "controlled foreign affiliate". The more general term "foreign affiliate" applies to ownership of 10% or more of a foreign corporation. One of the components of the definition of foreign affiliate in the tax law is that the corporation is non-resident. In this regard, a crucial provision within Canadian tax law to be discussed next is the definition of residency for a corporation.

Similar to the definition of residency for trusts previously discussed, the definition of residency for a corporation is based on the location of its "central management and control". As difficult as it may be to believe, it is entirely possible for a foreign corporation created in a jurisdiction outside of Canada to be considered a Canadian resident corporation.

The principle of "central management and control" for a corporation is founded on the notion of where the company's real business is carried on. Central management and control is usually the country in which the members of the board of directors meet and hold their meetings. Importantly, according to the courts, the residence of a company is not where central management and control is exercised according to the articles of incorporation, but where it is actually exercised. Potentially, actual control may be exercised by directors resident in one country; while directors resident in another country, who perhaps ought to have exercised control, stood aside from their directorial duties.

As a result, a foreign corporation that is principally controlled and managed by directors who reside in Canada may be deemed to be resident in Canada. This, in turn, means that the foreign corporation will be subject to Canadian taxation on its worldwide income, as if it were a Canadian corporation.

In the design of an asset structure that contemplates the formation of a foreign corporation, one must keep the definition of corporate residency foremost in mind.

The next and last section to this chapter, H. Foreign Activity Reporting Requirements, reviews various reporting requirements for Canadian residents who engage in foreign activities.

H. Foreign Activity Information Reporting

We have looked at various aspects of income taxation law that apply to Canadian residents who invest outside of Canada. The focus so far has been on income taxation, i.e., how the various items affect a resident's income tax return. The foreign tax credit, foreign dividend income, distributions from foreign trusts and foreign estates, the foreign accrual property income rules — these were presented in the light of how they affect a resident's taxable income and resulting tax payable reported in the annual income tax return filed with the CRA.

In addition to the annual income tax return filing requirement imposed on residents under the tax law, there are various information reporting requirements that may need to be fulfilled. It depends on the resident's specific foreign investment and foreign activities. Information reporting requirements are discussed next.

1. Form T1135 (Foreign Income Verification Statement)

The first place where you will typically find the CRA asking about your foreign investments is on your annual Form T1, officially referred to as the Income Tax and Benefit Return. Page two of Form T1 asks the question "Did you own or hold specified foreign property where the total cost of amount of all such property, at any time in 20xx, was more than CA$100,000?"If you answer "yes" to this question, then you are required to file Form T1135 (Foreign Income Verification Statement). Form T1135, filed annually, is due at the same time as the T1 income tax return.

The name of the form is somewhat of a misnomer because the form does not focus on foreign income as much as on information about your foreign property. That foreign property could yield foreign income, so the CRA uses the information in Form T1135 as an indirect way to determine if you are reporting foreign income, and paying tax on it, as required.

There are a few key aspects of the question on Form T1 referred to above to be considered in determining whether the answer should be yes. One relates to the monetary reporting threshold. It applies to cost (not value) and it is for the aggregate cost of all specified foreign properties. For example, if you made an initial investment of CA$30,000 in a foreign mutual fund in 2020 and an investment of CA$71,000 in foreign rental income property in 2021, then for 2020 your total cost would have been CA$30,000 — under the reporting requirement threshold - while for 2021 your total cost would have been CA$30,000 + CA$71,000 = CA$101,000 — an amount exceeding the reporting threshold of CA$100,000.

Another aspect is that the cost of specified foreign property received as a gift, a bequest or an inheritance is considered to be its fair market value on the date that the property was received.

A third aspect related to the CA$100,000 threshold is that it is in terms of Canadian dollars. Any specified foreign investments that you make in a foreign currency must be converted to Canadian dollars to arrive at your total cost of foreign investments in Canadian dollars.

A fourth key aspect is the types of specified foreign investments that fall under the reporting requirement. Not all types of foreign property fall under the definition for purposes of the CA$100,000 threshold. The instructions to Form T1135 state that the following items are reportable specified foreign property:

1. Funds or intangible property (patents, copyrights, etc.) situated, deposited or held outside Canada;
2. Tangible property situated outside of Canada;
3. A share of the capital stock of a non-resident corporation held by the taxpayer or by an agent on behalf of the taxpayer. (However, see the commentary a few paragraphs below regarding the requirement to include the shares in a "foreign affiliate" corporation in Form T1134 rather than Form T1135);
4. An interest in a non-resident trust that was acquired for consideration, other than an interest in a non-resident trust that is a foreign affiliate for the purposes of section 233.4 of the Act;

5. Shares of corporations resident in Canada held by you or for you outside Canada;
6. An interest in a partnership that holds a specified foreign property unless the partnership is required to file Form T1135;
7. An interest in, or right with respect to, an entity that is a non-resident;
8. A property that is convertible into, exchangeable for, or confers a right to acquire a property that is specified foreign property;
9. A debt owed by a non-resident, including government and corporate bonds, debentures, mortgages, and notes receivable;
10. An interest in a foreign insurance policy;
11. Precious metals, gold certificates, and futures contracts held outside Canada.

Notable among common types of foreign investments that do not fall within the definition of specified foreign property and, therefore, do not have to be reported, are these:

- Property held in retirement accounts. If you have retirement funds in a registered retirement fund that invests in equities, bonds or mutual funds and other foreign property - such as a Registered Retirement Savings Plan (RRSP, a Pooled Registered Pension Plan (PRPP), a Registered Retirement Income Fund (RRIF), a Registered Pension Plan (RPP), or a Tax-Deferred Savings Account (TFSA) - these do not fall under the definition of specified foreign property, and do not have to be reported.
- Foreign investments held in Canadian mutual funds. Investments in a Canadian mutual fund trust fall outside of the definition of foreign investment property and do not have to be reported. Note that this differs from directly owning shares of a foreign corporation through a Canadian broker; in such a case the foreign shares are reportable.
- Property used in a business. Property that is used or held exclusively in carrying on an active foreign business is excluded from the definition of foreign property. An example of this would be a warehouse in a foreign country that is used exclusively for storing inventory that is sold in the normal course of business.
- Personal-use property. Property in a foreign country that is used primarily for personal use and enjoyment does not have to be reported. Examples would be art, jewelry, stamps, coins, and vacation property.

That last one, vacation property, requires careful consideration. If vacation property is used primarily for personal use then it is not reportable as foreign investment property. Primarily for personal use means that more than 50% of the property's use is for your own personal purposes. Any days that the property is rented during the year would not be considered personal use. Thus, if the number of days during the year that the property is rented exceeds the number of days of personal use, then the property would not have been used primarily as personal-use property, and would therefore be considered specified foreign property and would have to be taken into account for purposes of the CA$100,000 reporting threshold.

The information reporting requirements for Form T1135 apply to direct ownership, i.e., to properties in your name. This can potentially convert what would otherwise be non-reportable property, if title to the property were in your own name, to reportable specified foreign property, if not held in your own name. Let's take an example. Assume that you have vacation property that you use more than 50% for personal use. As explained above, such vacation property would not fall into the category of specified foreign property. Hence, if this vacation property was in your name, it would not be reportable.

If, however, the vacation property is owned by a foreign corporation and you, in turn, own the shares of the foreign corporation, then those shares would be considered specified foreign property for purposes of the CA$100,000 threshold that determines whether you must file Form T1135.

Form T1135 applies not only to resident individuals but to Canadian residents in general, including resident corporations and trusts as well as resident partnerships. Regarding bullet point #3 (out of 9) above, note that a separate report, Form T1134 (Information Return Relating to Controlled and Not-Controlled Foreign Affiliates), may be required when the shares are in a "foreign affiliate" which is a non-resident foreign corporation in which the Canadian resident shareholder has ownership of 10% or more. This form is discussed momentarily.

Failure to file Form T1135 carries penalties that can be quite onerous. Penalties fall into five main categories:

- Failure to comply.

- Failure to furnish the information where the failure is done knowingly or due to gross negligence.
- Failure to furnish the information where the CRA issued a demand and the taxpayer knowingly due to gross negligence fails to comply with the demand
- Additional penalty for failing to comply after 24 months.
- False statement or omission where the taxpayer knowingly or due to gross negligence, makes false statements or omissions in an information return.

Depending on which of the above categories applies, and the amount of time that the reporting obligation remains delinquent, the penalty could run from the hundreds to the thousands of dollars.

The penalties above generally become more onerous as you move from the first one to the fifth one. For the fifth one the penalty is the greater of CA$24,000 or 5% of "whichever of the following the false statement or omission was made about: the cost of the foreign property; the fair market value of the property transferred or loaned to the trust; or the cost of the shares and indebtedness of the foreign affiliate." The penalties have the potential to be substantial. Ensuring that the Form T1135 filing requirements are fulfilled is crucially important.

Additional information reports related to foreign activities are presented next.

2. Form T1134 (Information Return Relating To Controlled And Not-Controlled Foreign Affiliates)

Form T1134 is the reporting vehicle through which a Canadian resident informs the CRA of any foreign corporations or trusts in which they have at least 10% ownership, whether directly or in combination with other related parties. The CRA can use the information filed with this form to help it determine if the taxpayer properly included income attributable to "foreign affiliates" in the taxable income reported in their tax return. As previously stated, the shares owned in a foreign affiliate are not included in Form T1135 described in the last section.

3. Form T1141 (Information Return In Respect Of Contributions To Non-Resident Trust, Arrangements Or Entities)

The purpose of this form is to inform the CRA of your contributions, loans or other transactions with foreign trusts. The CRA can use this information, among other reasons, to help it determine if you are sufficiently connected with the foreign trust such that it is deemed to be resident in Canada.

4. Form T1142 (Information Return In Respect Of Distributions From And Indebtedness To A Non-Resident Trust)

As a beneficiary of a foreign trust, you may have to complete and file Form T1142 if you received funds or property from, or were indebted to, a foreign trust during the year. Like Form T1141 just discussed, Form T1142 can help the CRA determine if the foreign trust is a deemed resident in Canada subject to taxation on its worldwide income. The filing of this form is not required if any of Forms T1141, T1134, or T1135 are filed in relation to the trust.

5. Form T106 (Information Return Of Non-Arm's Length Transactions With Non-Residents)

The T106 is an annual information return used to report non-arm's length transactions between reporting persons or partnerships and non-residents. The two operative terms in the title for this form are non-arm's length and non-residents.

The definition of non-arm's length is elaborate and complex. Essentially, non-arm's length means individuals connected by blood relationship, marriage, common-law partnership or adoption, as well as non-individual entities such as corporations and trusts that are considered non-arm's length in one way or another under the various rules that define the term non-arm's length.

For our purposes, we can think of non-arm's length more informally as "related party". Hence, transactions with non-resident related parties fall under the Form T106 filing requirements.

6. Information Reporting Forms Are Not To Be Ignored

In the review of information reporting forms above, you may have noticed a pattern among the forms: they solicit information that the CRA can use to help establish if you are properly including all foreign income in your individual income tax return. In a sense the CRA's philosophy with these forms is "you tell us all about your foreign activities so that we can be on the alert for what foreign income you should be reporting in your income tax return, and, most importantly, paying tax on."

The penalties for not filing required information reporting forms can be severe. Penalties associated with the failure to file Form T1135 (Foreign Income Verification Statement) were discussed above. Similar types of penalties apply for the failure to file other information reporting forms.

Depending on the circumstances, the penalties for failing to file required information reporting forms can be more severe than those related to not including the related foreign income in the tax return. One would be forgiven for feeling that these rules and potential penalties are draconian. Needless to say, ensuring compliance with these forms is critically important. A competent tax advisor will help you ensure that you are in full compliance with the law.

I. Chapter III Summary

This chapter covered several tax topics of importance to Canadian residents who engage in investment and other activities outside of Canada. International taxation is a complex area of tax law; the intent of the chapter is not to be all-inclusive but rather to focus on key income taxation issues, and important information reporting requirements, that commonly arise for residents with international activities.

The chapter topics included the specific income taxation rules applicable to various items such as the foreign tax credit, foreign dividend income, foreign trust and estates, and the foreign accrual property income (FAPI) rules. In the review of corporate residency the important point was made that a foreign corporation, in spite of it being created in a foreign jurisdiction, may nonetheless be considered as resident if its central management and control is principally based in Canada. Also covered were information reporting requirements related to a resident's foreign activities, and the specific CRA information reporting forms for those activities.

In the next chapter we shift our focus to the income taxation of non-residents. We explore various Canadian income taxation issues of interest to non-residents with investment and other ties to Canada.

CHAPTER IV

Income Taxation Of Non-Residents

The four stages of internationalization framework was introduced in Chapter I. Of the four, phases 3 and 4 involve non-residents. A non-resident is subject to Canadian income taxation on Canadian-source income only. This would be the situation for a non-resident Canadian in Phase 3. A Canadian in Phase 4 would not have any Canadian-source income, and would therefore not be subject to Canadian income taxation. Thus, the discussion in this chapter applies to a non-resident Canadian in Phase 3.

A non-resident's income tax on Canadian-source income is assessed through one of two methods, depending on the type of income. One method is through a non-resident withholding tax at the source, i.e., the Canadian payer of the income withholds tax before remitting a net-of-tax payment to the income recipient. The other method involves the filing of an income tax return by the non-resident individual in which the Canadian-source income is declared and tax paid thereon. The calculation of tax on this Canadian-source income serves as the basis for payment of tax to the CRA.

Let's examine each of these two income tax payment methods.

A. Income Subject To Tax Withholding (In General)

A non-resident's Canadian-source income that is subject to the non-resident withholding tax is called Part XIII income. Most types of Canadian-source income paid to a non-resident fall into this category of income, and are therefore subject to non-resident tax withholding.

The Income Tax Act specifically lists these types of income as subject to withholding:

1. Dividends;
2. Management fees;
3. Interest;
4. Estate or trust income;
5. Rents;
6. Royalties (including those from trademarks, patents, secret formulas, and certain visual media);
7. Timber Royalties;
8. Payments by cooperatives to members;
9. Pension benefits (including Canada Pension Plan and Old Age Security);
10. Non-competition amounts;
11. Retirement compensation arrangement benefits;
12. Retiring allowances (including termination and severance payments)
13. Registered retirement savings plans;
14. Deferred profit sharing plans;
15. Registered retirement income fund payments;
16. Several other types of payments.

To ensure proper compliance with Canada's non-resident withholding tax rules, you must notify your Canadian-source income payers that you are a non-resident of Canada, and advise them of your country of residence. With this information your Canadian-source income payers can withhold the correct amount of tax from their payments to you.

Under general Canadian tax law a Canadian payer of income to a non-resident recipient must withhold a tax of 25% from its payments to the non-resident. That is the general rule. However, the withholding tax rate may be reduced to less than 25% if there is a tax treaty between Canada and the recipient's country of residence. Hence, it is important for the payer to know not only that you are a non-resident, but also your country of residence.

With the non-resident withholding tax method, no Canadian income tax return must be filed. In essence, payment of tax through withholding serves to fulfill both income reporting and tax payment obligations for the non-resident.

Nevertheless, for some types of Canadian-source income that are subject to the non-resident withholding tax, an optional income tax return may be filed if it results in less tax than through the non-resident withholding tax method. Two instances in which it is often beneficial to file a tax return and pay tax on the basis of the tax return, rather than via withholding, are pension income and rental income. We discuss these next.

B. Income Subject to Tax Withholding (Pension Income)

1. Pension Income Payments: Tax Withholding Versus Tax Return

Most types of pension income payments to non-resident retirees are subject to the withholding tax rules. These include governmental pension benefits such as Canada Pension Plan (CPP) and Old Age Security (OAS) benefits, and private pension benefits such as payments from Registered Pension Plans (RPP), Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), and Pooled Registered Pension Plans (PRPPs). The general withholding tax rate on pension income payments is 25%, but if there is a tax treaty in place between Canada and the non-resident's country of residence, then the withholding tax rate may be less than 25%.

For example, under Canada's tax treaties with Mexico, Portugal and the United States, the withholding tax rate on most pension income payments is 15%.

Pension income is one type of income for which an aforementioned optional income tax return may be filed. An important tax planning opportunity is therefore presented regarding pension income. As a non-resident who is taxed on Canadian-source income only, the amount of tax withheld on your pension income may possibly be greater than it would otherwise be if you were to file a tax return, declare the pension income in that tax return, and pay tax on that basis.

For example, assume that your only Canadian-source income is monthly pension income of CA$6,000, composed of a combination of CPP and RRIF payments. This translates to CA$72,000 of total pension payments for the year. Assuming that the CA$72,000 in pension payments is your only Canadian-source income, and ignoring potential deductions and credits to which you may be entitled, let us calculate the amount of federal tax that would result if a tax return was filed. Assume that, based on the progressive tax bracket rates, the tax on the pension income would be $12,000. This would represent an average tax rate on the pension income of CA$12,000 ÷ CA$72,000 = 16.67%. Compared to paying tax under the withholding method, this signals the following for tax planning purposes:

- If the withholding tax rate is greater than 16.67%, then paying tax on the basis of filing a tax return rather than through withholding would be beneficial: the income tax return method would result in a lower tax.
- If the withholding tax rate is less than 16.67%, then paying tax on the basis of filing a tax return rather than through withholding would not be beneficial: the income tax return method would not result in a lower tax.

Using the amounts from the above example, if you resided in a country with which Canada does not have a tax treaty, you would be subject to annual tax withholding on your pension income of CA$72,000 x 25% = CA$18,000. This amount is higher than the CA$12,000 assumed above using the progressive tax rates for individuals. In this instance, it would behoove you to make the election to pay tax on your pension income on the basis of a tax return, rather than on the basis of withholding. Such an election is referred to as a section 217 election and will be discussed in the next subsection.

To continue with our numerical analysis for a moment, if the country in which the individual resides has a tax treaty with Canada under which the withholding tax rate on pension income payments is 15%, then the withholding tax on CA$72,000 of annual pension income would be CA$72,000 x 15% = CA$10,800. This amount is less than the CA$12,000 assumed above using the progressive tax rates; hence, in this case, it would be preferable to pay tax under withholding, rather than making a section 217 election and paying tax based on the filing of a tax return.

Let us now discuss the section 217 election.

2. Pension Income Payments: Electing To File A Tax Return Under Section 217

The election to file a tax return under section 217 is available for pension income payments only, although there are similar elections available under other sections of the Income Tax Act for other specific types of income.

The specific types of pension income payments set forth in ITA section 217 are:

- Old Age Security pension (see the note below);
- Canada Pension Plan and Quebec Pension Plan benefits;
- Most superannuation and pension benefits;
- Most registered retirement savings plan payments;
- Most pooled registered pension plan payments;
- Most registered retirement income fund payments;
- Death benefits;
- Employment insurance benefits;
- Certain retiring allowances;
- Registered supplementary unemployment benefit plan payments;
- Most deferred profit-sharing plan payments;
- Amounts received from a retirement compensation arrangement, or the purchase price of an interest in a retirement compensation arrangement;
- Prescribed benefits under a government assistance program;
- Auto Pact benefits.

The section 217 election must be applied in a combined way to all of the above types of pension income that you receive. If, for example, you receive both CPP and RRIF payments, then you must include both of these in the tax return that you file under your section 217 election.

Mechanically, you make the election by filing a non-resident tax return with the CRA on Form 5013-R (Income Tax and Benefit Return for Non-residents and Deemed Residents of Canada) and including with this return Form 5013-SC (Schedule C Electing Under Section 217 of the Income Tax Act). The filing due date is June 30 of the year after the taxation year.

Any withholding tax you paid during the year would be included in the tax return as income tax deducted in arriving at the refund or balance owing. For example, if the tax calculated in the tax return was CA$12,000 and you had paid CA$18,000 in tax withholdings during the year, you would show a refund due of CA$6,000 (CA$18,000 less CA$12,000) in the tax return.

3. Pension Income Payments: Reduction Of Amounts Withheld

In addition to filing a Form 5013-R tax return, it may also be a good idea for the non-resident taxpayer to file an application with the CRA for reduced withholding on Form NR5 (Application by a Non-Resident of Canada for a Reduction in the Amount of Non-Resident Tax Required to be Withheld for Tax Year ____). With the approval of this application, the payer(s) of your pension income are authorised to reduce the amounts they withhold on your pension payments to an amount approved by the CRA.

C. Income Subject to Tax Withholding (Rental Income)

1. Rental Income Payments: Tax Withholding Versus Tax Return

A non-resident of Canada who receives property income from Canadian rental property is by default subject to tax withholding on that income. The applicable withholding tax rate (25% or a lesser percentage under a treaty) is applied to the gross amount of rents. A potential cash flow issue with this is that the withholding tax rate is applied against gross income, not net income.

This can result in a disproportionately high amount of tax. Assume, for example, a non-resident who receives monthly income from Canadian rental property of CA$7,000, for an annual amount of CA$84,000 (CA$7,000 x 12). Also assume there is no applicable tax treaty and the general tax withholding rate of 25% applies. The annual amount of withholding tax would therefore be CA$84,000 x 25% = CA$21,000.

Let us further suppose that total deductible rental expenses for the year were CA$17,000. Net rental income from the rental property would thus be CA$67,000 (CA$84,000 minus CA$17,000). With a withholding tax of CA$21,000 (as calculated above), the overall tax rate on net rental income would be CA$21,000 ÷ CA$67,000 = 31%. This would be a high federal tax rate for most non-residents.

This outcome would be onerous as a result of, as mentioned, the withholding tax rate being applied on gross, not net, income. Depending on the amounts of deductible rental expenses (property taxes, interest, maintenance, repairs, management fees, capital cost allowance, etc.), the default approach to tax withholding on rental income could result in a significantly high amount of tax.

Fortunately, a relief option is available. As is the case with pension income, an election may be made to file an optional income tax return and pay tax on that basis rather than through withholding.

2. Rental Income Payments: Electing To File A Tax Return Under Section 216

The election to file a tax return under section 216 is available for rental income payments, and payments from timber royalties, only. The return is filed with the CRA using Form T1159 (Income Tax Return for Electing Under Section 216). The gross rental income amounts as well as the allowable deductions are entered on this form, and tax is calculated thereon using the graduated income tax rates for individuals. Any withholding tax paid during the year would be included in the tax return as "income tax deducted" in arriving at the refund or balance owing.

Accordingly, by filing an income tax return under section 216, a non-resident can recover the excess of taxes withheld during the year, by the payer of rental income, over the income tax calculated under the graduated income tax rates.

3. Rental Income Payments: Reduction Of Amounts Withheld

A separate but related form that can be considered for filing, in addition to Form T1159 just described, is Form NR6 (Undertaking to File an Income Tax Return by a Non-resident Receiving Rent from Real or Immovable Property or Receiving a Timber Royalty).

This form is signed by both the non-resident taxpayer and the taxpayer's agent who remits rental income payments (net of withholding tax) to the taxpayer. If the filing of this form is approved by the CRA, the non-resident taxpayer's agent is allowed to withhold tax using net rental income payments, i.e., gross rental income less allowable deductions.

The combination of filing Forms T1159 and NR6 with the CRA should result in better cash flow for the non-resident owner of the rental property: the withholding tax paid during the year will be lower when it is based on net rental income rather than gross rental income.

D. Recovering Excess Taxes Withheld

You may wonder, what can I do if the amounts of the taxes withheld are higher than they are supposed to be? The taxes withheld are, after all, remitted by the payer to the CRA, and once in the hands of the CRA the payer cannot get those amounts back from the CRA, in whole or in part.

Excess tax withholdings can arise for a variety of reasons. The payer may have applied an incorrect withholding tax rate if they were not aware of, or made a mistake regarding, the non-resident's country of residence. There could be a specific exemption under the tax treaty between Canada and the non-resident's country of residence that the payer did not take into account. The payer could simply have applied incorrect math in calculating the amount of tax to withhold. Or any other of a number of reasons.

If you as non-resident believe that too much tax was incorrectly withheld from your rental income or other payment, you can apply to the CRA for a refund of the excess. This is done on Form NR7 (Application for Refund of Part XIII Tax Withheld). The form requires that you enter various pieces of information, such as the details of type of payment, amount of taxes withheld, the payers' names, and the reason for the requested refund, and attach supporting documentation such as notarized affidavits; and copies of pertinent tax treaty rate exemptions. The form also requires the payer's certification and signature.

A successfully completed and filed Form NR7 should result in the CRA approving the form and remitting your refund.

E. Business Income and Employment Income

There are two main types of income for which the non-resident withholding tax rules do not apply: business income and employment income. ("Business income" refers to self-employment income earned in your own name as a sole proprietor.) For these two types of income, an annual income tax return must be filed and tax paid on that basis rather than via the non-resident withholding tax method.

Note that a non-resident who derives income from rental income properties conducted as an active business (versus as a passive investment) would not be subject to the non-resident withholding tax rules. The non-resident would be required to report this as business income by filing annual income tax returns.

Similarly, for other types of activities that generate business income rather than passive income, withholding tax rules do not apply, and payment of tax is based on the filing of a non-resident income tax return. The same is true of employment income received as an employee of a Canadian employer.

F. Chapter IV Summary

In this chapter we examined various tax topics related to non-residents who have investment and other ties to Canada. The chapter discussed the variety of types of income subject to withholding under the general tax withholding rules, and how the general withholding tax rate of 25% may be reduced by virtue of a tax treaty between Canada and the non-resident's country of residence.

Withholding rules related specifically to pension income and passive rental income were reviewed. With pension income and passive rental income, elections under Income Tax Act (ITA) sections 217 and 216, respectively, are available. These elections allow the non-resident to pay tax on the basis of filing a tax return rather than on the basis of withholding.

For a non-resident who believes too much tax was incorrectly withheld, there is a mechanism for recovering such excess tax withheld. The specific form and procedure for this was described.

The withholding tax rules do not apply to business income and employment income. For these, a tax return must be filed, the income declared, and tax paid accordingly. Rental income that is from an active rather than a passive activity is considered business income.

We next turn our attention to the year that a Canadian resident becomes a non-resident: the so-called departure year.

CHAPTER V

Income Taxation In The Departure Year

Chapters III and IV covered income taxation rules for the resident and the non-resident, respectively. We now consider the taxation year in which a Canadian's tax residency status changes from resident to non-resident. This taxation year is referred to as the departure year.

The departure year for an expatriating Canadian can be thought of as being split into two parts: (1) the first part of the year during which the individual is still a resident (i.e., a part-year resident), and (2) the second part of the year during which the individual is a non-resident (i.e., a part-year non-resident). The taxation rules discussed in Chapter III apply to the resident portion of the year, while the rules covered in Chapter IV apply to the non-resident portion of the year.The T1 income tax return for the departure year will include information and income for both of these parts of the year.

The resident portion of the departure year tax return includes the departure tax. The departure tax is not a separate tax per se; rather, it is the additional income tax imposed under the tax laws as a result of special rules for emigrating Canadians. That is to say, the special rules that apply to the part-year resident portion of the departure year can result in the payment of income tax beyond what would otherwise have been paid in the absence of the departure tax rules. Let's go into the details.

A. How The Departure Tax Works

The essence of the departure tax rules is the imposition of capital gains tax on the deemed disposition of certain assets on the last day as a resident, or stated differently, the last day before non-resident status begins.

As an example, assume that an individual owns a portfolio of mutual funds with a cost base of CA$50,000 and a fair market value of CA$80,000, such that there is a built-in unrealized capital gain of CA$30,000 (CA$80,000 minus CA$50,000). Under the departure tax rules, the individual is deemed to have sold the mutual funds for their fair market value of $80,000 on the last day that the individual was a resident.

This results in a deemed capital gain of CA$30,000; assuming the capital gain is subject to the 50% inclusion rate (versus the two-thirds inclusion rate), one-half of this capital gain amount, or CA$15,000, is thereby includable as a taxable capital gain in the departure year tax return. Note that this outcome is despite the fact the individual did not actually sell the mutual funds and get cash from the sale. This is how the departure tax operates.

The first step in complying with the departure year rules is completing Form T1161 (List of Properties by an Emigrant of Canada). Filing of this form with the CRA is required if the total fair market value of all the property you owned on your last day as a tax resident, excluding certain types of property not counted for this purpose, exceeds CA$25,000. It is easier to talk about the types of property excluded than it is to talk about the types of property included. These are the types of property excluded from the tally of the CA$25,000 threshold, as listed in CRA Form T1161:

- Cash (including bank deposits);
- Pension plans, annuities, registered retirement savings plans, pooled registered pension plans, registered retirement income funds, registered education savings plans, registered disability savings plans, tax-free savings accounts, deferred profit-sharing plans, employee profit-sharing plans, employee benefit plans, salary deferral arrangements, retirement compensation arrangements, employee life and health trusts, and rights or interests in certain other trusts;
- Property you owned when you last became a resident of Canada, or property you inherited after you last became a resident of Canada, if you were a resident of Canada for 60 months or less during the 10-year period before you emigrated and the property is not taxable Canadian property;
- Any item of personal-use property (such as your household effects, clothing, cars, collectibles) that has a fair market value of less than $10,000.

Accordingly, any property excluded as per above would not be included in determining if the CA$25,000 threshold is exceeded and Form T1161 must be filed. Note: the instructions to Form T1161 state that the list of items shown above is not complete, and refers the reader to ITA subsection 128.1(10) for a complete list. Hence, it would be prudent for you or your tax adviser to review that subsection during the preparation of Form T1161.

Form T1161 must be completed and attached to your part-year resident tax return (which represents your final tax return filed as a resident) if the total of all your property, excluding the items above, exceeds CA$25,000. The requirement to file this form does not, however, in and of itself mean that you are subject to the departure tax rules.

The next step in complying with the departure year procedures is to identify which of the property that you own is subject to the departure tax rules; not all property is subject to these rules. Again, it is easier to review the types of property excluded rather than to review the types of property that are included. The following types of property are excluded from the departure tax rules, as per CRA Form T1243 (Deemed Disposition of Property by an Emigrant of Canada):

- Canadian real or immovable property, Canadian resource property, and timber resource property;
- Canadian business property (including inventory) if the business is carried on through a permanent establishment in Canada;
- Pension plans, annuities, registered retirement savings plans, pooled registered pension plans, registered retirement income funds, registered education savings plans, registered disability savings plans, tax-free savings accounts, deferred profit-sharing plans, employee profit-sharing plans, employee benefit plans, salary deferral arrangements, retirement compensation arrangements, employee life and health trusts, rights or interests in certain other trusts, employee security options subject to Canadian tax, interests in certain personal trusts resident in Canada, and interests in life insurance policies in Canada (other than segregated fund policies);
- Property you owned when you last became a resident of Canada, or property you inherited after you last became a resident of Canada, if you were a resident of Canada for 60 months or less during the 10-year period before you emigrated.

Note: Form T1243 states that the above list is not complete, and refers the reader to ITA subsection 128.1(10) for a complete list. Hence, it would be prudent for you or your tax adviser to review that subsection in the preparation of Form T1243.

TO ILLUSTRATE HOW FORMS T1161 AND T1243 WORK, LET US FIRST CONSIDER FORM T1161, USING THREE EXAMPLES.

Assume three individuals (#1, #2 and #3) with the following portfolios of property:

		#1	#2	#3
1.	**Cash** (including bank deposits)	CA$60,000	CA$60,000	CA$60,000
2.	**RRSP**	CA$900,000	CA$900,000	CA$900,000
3.	**Automobile**	CA$9,000	CA$9,000	CA$9,000
4.	**Clothing**	CA$8,000	CA$8,000	CA$8,000

5.	**Household effects**	CA$9,500	CA$9,500	CA$9,500
6.	**SUV**	CA$12,000	CA$12,000	CA$12,000
7.	**Personal residence** (#1 rents their residence)		CA$1,300,000	CA$1,300,000
8.	**Inventory and equipment used in Canadian business**		CA$600,000	CA$600,000
11.	**Foreign rental property** (condo)			CA$900,000
10.	**Stocks, bonds, mutual fonds portfolio**			CA$500,000

Value of items 1 through 10	CA$998,500	CA$2,898,500	CA$4,298,500
Exclude items 1 through 6 (for Form T1161)	CA$998,500	CA$998,500	CA$998,500
Value of items 8 through 10 (for Form T1161)	CA$0	CA$1,900,000	CA$3,300,000

For the first individual, no filing of Form T1161 is required since the total value of their property that is includable for purposes of the Form T1161 calculation, CA$0, is below the CA$25,000 threshold. For #2 and #3, Form T1161 must be filed. This is because the total values of the assets for purposes of Form T1161, CA$1,900,000 and CA$3,300,000, respectively, are above the CA$25,000 threshold.

NEXT, WE DETERMINE WHICH PROPERTY IS SUBJECT TO THE DEPARTURE TAX RULES, AS PER THE INSTRUCTIONS TO FORM T1243.

Individual #1's property would not be subject to the departure tax rules, as a result of having already determined that #1 is not required to file Form T1161. For individuals #2 and #3, we proceed to calculate the values of their properties that are potentially subject to the departure tax rules:

		#2	#3
1.	**Cash** (including bank deposits)	CA$60,000	CA$60,000
2.	**RRSP**	CA$900,000	CA$900,000
3.	**Automobile**	CA$9,000	CA$9,000
4.	**Clothing**	CA$8,000	CA$8,000

5.	**Household effects**	CA$9,500	CA$9,500
6.	**SUV**	CA$12,000	CA$12,000
7.	**Personal residence**	CA$1,300,000	CA$1,300,000
8.	**Inventory and equipment used in Canadian business**	CA$600,000	CA$600,000
9.	**Foreign rental property** (condo)		CA$900,000
10.	**Stocks, bonds, mutual fonds portfolio**		CA$500,000

Value of items 1 through 10	CA$2,898,500	CA$4,298,500
Exclude items 1 through 8 (for Form T1243)	CA$2,898,500	CA$2,898,500
Value of items subject to departure tax (for Form T1243)	CA$0	CA$1,400,000

The next-to-last row above shows that we exclude items 1 through 8:

- Item 1 is cash; it is excluded because there is no built-in capital gain with cash, i.e., the cost base and fair market value of cash is the same, and the deemed capital gain must therefore be zero.
- Items 2 through 8 are excluded because they fall under the types of property not subject to the departure tax rules, as per the list of excludable types of property indicated on Form T1243 as described above.

With individual #2, that leaves a total value of CA$0 for purposes of the departure tax rules, and, therefore, #2 would not be subject to the departure tax.

Let us now consider individual #3. This individual has a similar but different situation to that of #2. The difference is that #3 has foreign rental property (a condo) and a stocks, bonds and mutual funds portfolio, which #2 does not. Let us assume that the cost base of the foreign rental property was CA$600,000 and the cost base of the stocks, bonds and mutual funds portfolio was CA$370,000.

Under the departure tax deemed disposition rules, the capital gains on these would be, respectively, CA$300,000 (CA$900,000 fair market value less CA$600,000 cost base) and CA$130,000 (CA$500,000 fair market value less CA$370,000 cost base).

As a result, #3 would have taxable capital gains based on deemed dispositions of CA$300,000 on the foreign rental property and CA$130,000 on the stocks, bonds and mutual funds portfolio. The resulting taxable capital gains must be included in #3's income tax returnfor the departure year.

To reinforce an earlier point: the resulting taxable capital gains on the deemed dispositions will result in departure tax in spite of the fact that no actual sale of the property was made, and no cash from sale was received. Depending on one's cash flow situation, this may or may not be significant. Either way, however, these examples illustrate the importance of "previewing" the departure tax with estimated calculations before actually transitioning from resident to non-resident, so as to take whatever available action may be available to minimise the impact of the departure tax if desired.

There are a few additional aspects of the departure tax , many of which are technically complex and beyond the scope of this book, but it is worth mentioning a couple here. One relates to elections that are available. For example, one election allows the individual to defer payment of the departure tax. Another election allows the individual to include otherwise non-taxable property as taxable for purposes of the departure tax. One or both of these elections could be beneficial for tax reduction or cash flow management, depending on the circumstances. While these are elections (not mandatory), it is sound tax planning to consider them, work through the calculations, and determine how and whether they may be of benefit.

Let us next explore the election to defer payment of the departure tax, and subsequently the election to treat property not subject to the departure tax as if it were subject to the tax.

B. Election To Defer Payment Of The Departure Tax

Section A (How the Departure Tax Works) above explains that the essence of the departure tax is additional income tax that arises from deemed dispositions that result in taxable capital gains. These deemed dispositions are applicable for certain types of property that are subject to the departure tax, but not necessarily all property owned by the individual at departure.

An election is available to defer payment of the departure tax. Under this election, the taxpayer pays the departure tax later, without interest, when the property is actually sold or otherwise disposed of. The election is made by attaching Form T1244 (Election, Under Subsection 220(4.5) of the Income Tax Act, to Defer the Payment of Tax on Income Relating to the Deemed Disposition of Property) to the departure year tax return. This form notifies the CRA that the taxpayer is electing to defer payment of the departure tax.

Form T1244 informs the CRA of the details of the property that you are electing to include under the election, and calculates the amount of departure tax associated with that property. If the form shows that the departure tax is CA$16,500 or less (or CA$13,777.50 or less for emigrating Quebec residents), no security deposit is required. If, on the other hand, the departure tax is greater than CA$16,500 (or CA$13,777.50 for emigrating Quebec residents), then security must be deposited with the CRA.

It is important to file the income tax return with its attached Form T1244 as early as possible, well in advance of the April 30 deadline if possible, so as to allow sufficient time to make acceptable arrangements with the CRA. If a security deposit is required (i.e., as per above, the departure tax is more than CA$16,500, or more than CA$13,777.50 for emigrating Quebec residents), it must be deposited with the CRA in accordance with the arrangements made with the CRA.

This election can be particularly helpful where (1) there will be a departure tax but no security deposit required, and (2) there will be a significant departure tax but the individual does not want to liquidate property, and receive cash on its liquidation, until sometime later after departure.

C. Election To Treat Non-Taxable Property As Taxable For The Departure Tax

The election to treat property not subject to the departure tax as if it were subject to the tax is made on Form T2061A (Election by an Emigrant to Report Deemed Dispositions of Taxable Canadian Property and Capital Gains and/or Losses Thereon). As stated in the instructions to the form, the types of property for which this election is available are:

- Real property in Canada, Canadian resource property, or timber resource property; or
- Capital property used in, eligible capital property in respect of, or property described in the inventory of a business you carried on through a permanent establishment in Canada at the time you ceased to be a resident of Canada.

When might it be useful to make this election? One type of situation would be when already-incurred capital losses could be used to offset the capital gains that would arise from the deemed disposition of property under the departure tax rules. Assume, for instance, that individual #3 from the examples in the last section had incurred capital losses from the sales of various capital property of CA$100,000 prior to the departure date. Further assume that the inventory and equipment used in Canadian business has a cost base of CA$500,000, and therefore a built-in capital gain of CA$100,000 (CA$600,000 fair market value less CA$500,000 cost base).

By making the election to treat the inventory and equipment used in Canadian business as if it were subject to the departure tax, individual #3 would use the CA$100,000 in capital losses that may otherwise not have been used for a period of time, or perhaps never at all, immediately recognize a CA$100,000 capital gain, and offset the two against each other for a zero net tax effect.

D. Chapter V Summary

In this chapter we discussed the departure tax, which applies in the year that a Canadian changes their residency status from resident to non-resident, otherwise known as the departure year. The departure tax is not a separate tax per se, but rather the additional tax that results from the capital gains on the deemed dispositions of certain property. The departure tax is levied upon the departing individual in spite of the fact that no actual sale of the property, and therefore no cash receipt from the sale, actually takes place.

It is possible to defer the departure tax by making an election for some or all of the property subject to the departure tax. If the amount of departure tax that is deferred is above a prescribed threshold amount, a security deposit must be arranged with and paid to the CRA. The deferral of departure tax stays in effect until such time that the property is actually sold.

It is also possible to elect to treat property that does not fall under the departure tax rules as if it did fall under those rules. Under this election, the property is deemed to have been disposed at departure, and any capital gains or losses from its deemed disposition it included in the individual's part-year resident tax return. This election could be useful, depending on circumstances.

CHAPTER VI

Conclusion

Canadian investors are among the most internationally-aware residents in the world. This is manifested by the large numbers of Canadian residents who invest overseas, and the large numbers of Canadians moving overseas who become non-residents.

This book discusses the Canadian income taxation of residents and non-residents. Chapter I introduces a framework referred to as the "Phases of Internationalization" to set the stage for the review of the different sets of income tax rules that apply to residents and non-residents.

Chapter II establishes two key fundamentals of the Canadian income tax system. One is the tax residency rules that define whether an individual is a resident or a non-resident for tax purposes. The other one is bilateral tax treaties, which Canada currently has with about 95 countries. Tax treaties take precedence over general Canadian tax laws. It is therefore of utmost importance to know whether and how a tax treaty impacts an individual's tax affairs.

The income taxation of residents is reviewed in Chapter III. The special taxation rules related to a variety of items are discussed in this chapter: the foreign tax credit, foreign dividend income, foreign trusts, foreign estates, Foreign Accrual Property Income (FAPI) rules, and information reporting for various types of foreign activities.

In Chapter IV we examined the income taxation of non-residents on Canadian-source income. Non-residents pay tax on their Canadian-source income (1) through the non-resident withholding tax or (2) on the basis of a filed non-resident income tax return. Which of these two methods applies depends on the type of income. For some types of income subject to the non-resident withholding tax there is an election available to file a tax return and pay tax on that basis, rather than through withholding. Depending on circumstances and one's individual situation, these elections can be availed of to reduce the overall tax that is paid to the CRA.

The departure tax is reviewed in Chapter V. It is not a separate tax per se; rather, it is the additional income tax imposed in the year that a resident becomes a non-resident, known as the departure year, because of special departure tax rules. Under the special departure tax rules certain property is deemed to have been disposed of at their fair market value on the last day of residency, triggering taxable capital gains or losses on the deemed dispositions. The chapter discussed two elections that could be considered to manage the effect of the departure tax: the election to defer payment of the tax, and the election to treat property not subject to the departure tax as if it were subject to the tax.

The Canadian income tax system is composed of a large and complex body of law, regulations and rules. It has unique complexities in regard to the taxation of residents on income from their foreign activities, and the taxation of non-residents on their Canadian-source income. This book is intended to help the globally-minded Canadian understand those complexities, and manage them so as to minimize their income taxes to the extent possible.

While the book's discussion of the complex topic of Canadian international taxation is not all inclusive, it covers what the author believes to be the most common topics of interest for residents and non-residents.

APPENDIX

International Remote Work

Indications are that the trend of working remotely as a "digital nomad" that started before, and accelerated during, the 2020 coronavirus outbreak has continued. Among the reasons for this is the advancement of technology, the wide acceptance of virtual meetings as a substitute for face-to-face meetings, and the offering of digital nomad visas by a number of countries.

A digital nomad visa allows an individual to stay in the host country to perform remote work. At this writing more than 60 countries offer digital nomad visas, some for durations of up to 12 months. The conditions for a digital nomad visa usually include that the employer or clients for whom remote work is performed must reside outside of the host country.

Digital nomad visas are often renewable for an additional period of stay in the host country. Some digital nomad visas come with tax benefits, i.e., a reduced or zero host country tax burden. A digital nomad visa is seen by many as a great way to experience living in other countries while earning income to fund their lifestyle.

This appendix discusses tax planning issues related to international remote work from two perspectives:

- A Canadian resident performing remote work from within Canada for a foreign employer or client.
- A non-resident of Canada performing remote work from a country outside of Canada for a Canadian employer or client.

Regarding the second perspective, it is important to remember that moving to a country outside of Canada does not automatically make one a non-resident of Canada for tax purposes. Depending on the facts and circumstances, Canadian tax law may hold that an individual continues to be a Canadian tax resident after relocating abroad to work remotely under a digital nomad visa. Refer to Chapter II for an explanation of the rules that determine whether an individual is a resident or a non-resident for tax purposes.

For purposes of this appendix, the remote worker under the second scenario above is assumed to be a non-resident of Canada for tax purposes.

For both of the above scenarios, these are key tax issues to be considered:

- Is the remote work relationship that of employee-employer or independent contractor-client?
- What are the Canadian income tax laws that come into play for the remote worker and their employer or customer?
- What other tax obligations, e.g., sales taxes and Canadian Pension Plan contributions, apply for the remote worker and their employer or customer?

The first section that follows discusses the tax ramifications based on the relationship between the remote worker and the party for whom work is performed. Is it an employee-employer relationship or an independent contractor-client relationship? This question is often treated more lightly than it should be. However, the answer to the question can make a significant difference in how the remote worker, as well as the party for whom worked is performed, is taxed.

Following the first section are sections that address the two main scenarios set forth above, i.e., (1) a Canadian resident working remotely within Canada to perform services for a foreign employer or client and (2) a non-resident of Canada working remotely from outside of Canada to perform services for a Canadian employer or client.

A. Employee or Independent Contractor?

Under both of the scenarios presented in introduction above, the remote worker's income will generally be taxed under Canadian income tax law, either because (1) the remote worker is a tax resident of Canada subject to income taxation on worldwide income (first scenario) or

(2) the remote worker's income, from services provided to a Canadian company or other resident, is Canadian-source income (second scenario). Furthermore, the income will be either employment income or business income, depending on whether the relationship is employee-employer or independent contractor-client. In some cases, as discussed later, the remote worker's income in the second scenario is exempt from Canadian income taxation if there is a tax treaty between Canada and the remote worker's country of residence.

The income tax ramifications of employment income versus business income are different, both for the remote worker and for the party for whom services are performed. The principles that define whether a relationship is that of employee-employer or independent contractor-client have been established over many years by decisions of the courts. The Canada Revenue Agency (CRA) has published various guidance documents on this topic. One, for example, is RC4110(E) Employee or Self-employed.

Let us examine the differences in taxation between an employee-employer relationship and an independent contractor-client relationship.

1. Canadian Tax Ramifications to the Remote Worker

Income taxation: In terms of Canadian income taxation for the remote worker:

- Employee status means taxable Canadian employment income plus income tax deductions for employment expenses.
- Independent contractor status means, with some exceptions, taxable Canadian business income plus income tax deductions for business expenses.
- As a general rule, there is a greater number of expenses that are deductible as business expenses for an independent contractor as compared to employment expenses for an employee.

CPP and EI: Another difference in taxation between employment versus independent contractor status relates to the Canada Pension Plan (CPP) and Employment Insurance (EI).

- As an employee, CPP and EI must be withheld by the employer from the employment income paid to the remote worker.
- As a self-employed independent contractor, the remote worker is required to make CPP contributions based on net business income. Contributions to EI are not required of self-employed individuals but are optional for those who wish to participate in the EI system.

Sales tax: A big difference between the two statuses can result in terms of sales tax. In Canada the sales tax, called the Goods and Services Tax (GST), is in force in all provinces and territories except Quebec, where the Quebec Sales Tax (QST) applies.

- An employee does not have to collect GST or QST on their employment income.
- An independent contractor may be obligated to collect GST or QST on payments from their clients, depending on factors such as the type of service provided.
- This CRA web page has information on the GST. Note that, as stated in the linked information, "small suppliers" with annual taxable sales of $30,000 or less are exempt from registering for and collecting sales tax, although they may choose to do so anyway.

While the details related to income taxation, CPP and EI, and sales taxation issues just mentioned are beyond the scope of this appendix, they are introduced here so that, if you are planning to engage in a remote work arrangement, you may be informed.

2. Canadian Tax Ramifications to the Party for Whom Services are Performed

The flip side of the issues mentioned in the last subsection relate to the party for whom services are provided by the remote worker.

- If the party receiving the services falls under the definition of employer, they are responsible for complying with the income tax rules on employee withholdings of income tax, CPP and EI.
- On the other hand, if the party receiving the services falls under the definition of client in an independent contractor-client relationship, they will only need to be concerned with paying the independent contractor fee,

plus any applicable sales tax. It would be the remote worker's responsibility to collect any required sales tax.
- In the scenario where the client is based in Canada and the independent contractor is a non-resident, the Canadian-based client may be required to comply with either the Regulation 105 withholding rules or the non-resident withholding tax rules. These are discussed below in Section C, Non-resident of Canada Working Remotely Outside of Canada for a Canadian Employer or Client.

The details of the income taxation, CPP and EI, and sales taxation issues just mentioned are beyond the scope of this appendix. However, they are introduced here so that, if you are planning to engage in a remote work arrangement, you may be informed.

3. General Comment About the Employee versus Independent Contractor Issue

When a company hires the services of a remote worker, it is usually the case that the company prefers for the remote worker to be an independent contractor rather than an employee. The company and the remote worker will oftentimes enter into an independent contractor agreement which contains terms and conditions that support the argument that the relationship is that of independent contractor-client rather than employee-employer. It is important to bear in mind, however, that if the CRA or Revenu Quebec were to audit or otherwise review the tax returns of either the remote worker or the company paying for services, regardless of what is stated in the independent contractor agreement they may conclude that the relationship is not that of independent contractor-client, but rather of employee-employer.

Therefore, it must be kept in mind that a taxing authority could perform such a review and ultimately assess additional taxes, interest and penalties to one or both of the remote worker and the party paying for services. Hence the importance of diligence and sound planning when entering into a remote worker arrangement. The responsibility for determining whether the relationship is that of employee-employer or independent contractor is most commonly assumed by the party hiring the services of the remote worker. Nevertheless, it would be a good idea for the remote worker to discuss the tax issues and risks raised in this appendix with the party hiring their services, so that a sound conclusion and decision is reached jointly.

B. Canadian Resident Working Remotely Within Canada for a Foreign Employer or Client

The topics discussed in the subsections that follow are:

1. Tax issues for the Canadian remote worker as employee
2. Tax issues for the Canadian remote worker as independent contractor
3. Tax issues for the foreign payer of services as employer
4. Tax issues for the foreign payer of services as client

1. Tax issues for the Canadian remote worker as employee

The tax issues for a Canadian resident working remotely as an employee for a foreign employer are straightforward, assuming that the foreign employer follows the rules for employers related to income tax withholding, CPP and EI. The employee will receive a T4 slip from the employer after year-end and, based on the information in the slip, report employment income, CPP contributions and EI contributions in their annual T1 tax return. If no T4 slip is received from the employer, the remote worker will nevertheless be required to report these items in their T1 income tax return and will therefore have to gather the information in some way.

The remote worker will also be entitled to claim work-at-home expenses and other employment expenses in their tax return. Information on this is available in CRA publication T4044(E) Employment Expenses.

2. Tax issues for the Canadian remote worker as independent contractor

As an independent contractor, the remote worker will have to comply with income tax, CPP and possibly sales tax obligations.

For income tax purposes, a remote worker's income is reportable as business income in the annual T1 tax return. Business expenses may be claimed to offset income. Information on deductible business expenses is available in CRA Guide T4002 on Self-employed Business.

In addition to income tax, the independent contractor is also liable for CPP contributions, which are based on net business income, i.e., income less deductible expenses. The CPP contribution amount is calculated in the T1 tax return and included as an additional amount to be paid with the T1 tax return.

Regarding sales tax, an important rule of thumb to be kept in mind is that services provided to clients within Canada are taxable, but services provided to clients outside of Canada are not. Thus, a remote worker working as an independent contractor would not be liable for collecting Canadian sales tax on payments for services provided to clients outside of Canada. Depending on the client's country of residence, there may be sales tax obligations to the that country, something that would need to be researched.

3. Tax issues for the non-resident payer of services as employer

A non-resident company or other entity based outside of Canada that hires a Canadian resident as an employee for remote work must comply with regulations related to income tax, CPP and EI regulations for employers. This CRA publication provides information for employers: CRA Guide T4001 Employer's Guide.

Aside from the tax issues related to the hiring of a Canadian resident employee, if the non-resident employer engages in income-generating business in Canada, it may be liable for Canadian income taxes. The general rules for this are:

- If there is no tax treaty between Canada and the employer's country of residence, the Canadian-source income is taxable and therefore reportable in an annual Canadian income tax return.
- If there is an applicable tax treaty, there would likely be no income tax obligation provided that the non-resident company does not have a permanent establishment in Canada. A discussion of this topic is beyond the scope of this book; however, the following link has helpful information on the concept of permanent establishment: Business Tax Canada web page.

4. Tax issues for the non-resident payer of services as client

Where there is an independent contractor-client relationship (versus an employee-employer relationship), the non-resident client does not have any special tax considerations to be taken into account, unless the client also derives income from engaging in business in Canada. In this case, as stated in the previous subsection, a determination will have to be made whether an applicable tax treaty's provisions and whether there are Canadian income tax filing requirements.

C. Non-resident of Canada Working Remotely Outside of Canada for a Canadian Employer or Client

The following subsections discuss:

1. Tax issues for the non-resident remote worker as employee
2. Tax issues for the non-resident remote worker as independent contractor
3. Tax issues for the Canadian payer of services as employer
4. Tax issues for the Canadian payer of services as client

1. Tax issues for the non-resident remote worker as employee

Employment income received from a Canadian employer is considered Canadian-source income subject to Canadian income taxation, whether the employee resides in Canada or outside of Canada. In some situations in which there is an applicable tax treaty, it is possible that the remote worker's employment income will not be taxable in Canada but will be taxable in the country of residence. This would need to be researched. If the employment income is taxable in Canada, the remote worker will be required to file an annual T1 tax return to report the income and pay tax thereon.

2. Tax issues for the non-resident remote worker as independent contractor

In this scenario the remote worker's business income will be taxable in Canada unless there is an applicable tax treaty that holds otherwise. If the business income is taxable, the remote worker will be required to file an annual T1 tax return to report the income and pay tax thereon.

Most tax treaties that Canada has with other countries provide that a non-resident independent contractor's business income is not taxable in Canada unless the independent contractor has a "permanent establishment". A discussion of this topic is beyond the scope of this book; however, the following link has helpful information on the concept of permanent establishment: Business Tax Canada web page.

It would not be common for a non-resident remote worker to have a permanent establishment in Canada. Therefore, under an applicable tax treaty the business income received by the remote worker for independent contractor work would probably be exempt from Canadian income taxation. The income would likely be taxable by the country of residence, however.

A few complexities come into play when a non-resident remote worker provides services to a Canadian company or other Canadian resident as an independent contractor. These relate to potential withholding obligations imposed on the Canadian company receiving the remote worker's services. Refer to subsection C.4. below for a discussion of these complexities.

Separate from potential income tax considerations, an independent contractor providing services to a Canadian company or other Canadian resident may have GST or QST tax collection obligations, as briefly mentioned in subsection A.1. above. If GST or QST obligations apply, the remote worker would include the sales tax in their invoices to their Canadian resident client and collect the sales tax on that basis. It is worth noting that the exemption from income taxation under a tax treaty provision would not extend to the sales tax. Thus, you could have a situation in which a non-resident remote worker would have no income tax obligation to Canada but would have a sales tax obligation.

3. Tax issues for the Canadian payer of services as employer

In an employee-employer relationship, the general rule is that the Canadian employer will have to fulfill income tax withholding obligations on employment income paid to non-resident employees. However, an applicable tax treaty may override this general rule. As stated in subsection C.1. above, this is something that would need to be researched.

Based on the provisions of an applicable tax treaty, the employee may apply with the CRA for a Regulation 102 waiver of income tax withholding. Once the waiver is obtained from the CRA, the employee provides the approved waiver document to the employer so that the employer may discontinue withholding income tax from the employee's pay. This topic is beyond the scope of this appendix, however, this CRA web page provides information on Regulation 102.

4. Tax issues for the Canadian payer of services as client

A Canadian payer of services to a non-resident remote worker may have an obligation to withhold income tax on those payments. Described next are two different sets of tax rules that may apply. The applicable set of rules depends on the level of services provided by the non-resident remote worker to the Canadian company or other Canadian resident.

Regulation 105 tax withholding for lower-level services: For "lower" levels of service a set of rules referred to as Regulation 105 applies. Under Regulation 105, a Canadian resident who pays for services from a non-resident is required to withhold a provisional income tax, remit the withheld tax to the CRA, and submit year-end reporting on these withholdings to the CRA. The non-resident payee would have to file a Canadian T1 income tax return to report the income as business income, calculate the income tax, include the provisionally withheld taxes as a credit in the tax return, and either pay a balance owing or request a tax refund based on the difference between the provisionally withheld tax and the actual tax.

If the remote worker resides in a tax treaty country and does not have a permanent establishment in Canada, then under most of Canada's tax treaties their business income from independent contractor services is not subject to Canadian income taxation. In such case the non-resident remote worker may apply to the CRA for a waiver from Regulation 105 withholding. If the CRA grants the waiver, the remote worker can provide the approved waiver document to the Canadian client, which instructs them to discontinue withholding the 15% provisional tax on payments made to the non-resident remote worker. Without having any Regulation 105 tax withholding on payments from their client, and with no Canadian income taxation on their income under a tax treaty exemption, the remote worker will then not have any need to file a Canadian income tax return.

Non-resident tax withholding for higher level services: The other set of rules referred to above relates to the non-resident withholding tax on services that are considered to be "management or administrative fees". For such services, Canada's non-resident withholding tax rules require that the Canadian resident payer withhold 25% on payments to the non-resident, remit the withheld tax to the CRA, and submit year-end reporting to the CRA on those payments.

Essentially, "management or administrative fees" are fees paid for high-level services such as "planning, direction, control, co-ordination, systems or other functions at a managerial level". This would be in contrast to services for lower level or routine tasks, which fall under the Regulation 105 rules just described above. The CRA defines "management or administrative fees" in its Interpretation Bulletin IT-468R.

Most commonly a remote worker's services would be lower level and/or routine in nature, and not be of a "management or administrative" nature. Accordingly, Regulation 105 withholding rather than "management or administrative fees" non-resident tax withholding would usually apply. In cases where management or administrative withholding would apply, however, it is important to note that many of Canada's tax treaties provide an exemption from taxation on an independent contractor's management or administrative fees. This would mean that the Canadian company would not need to apply the non-resident withholding tax to payments it makes to the remote worker. It is therefore important to determine, when the remote worker's services are "management or administrative" in nature, whether there are applicable tax treaty exemptions for this type of non-resident tax withholding.

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